ACCA APPROVED CONTENT PROVIDER

ACCA DipIFR

Study Text

Diploma in International Financial Reporting

Study Text for exams
in December 2014 and June 2015

APPROVED ACCA CONTENT

Content reviewed by
ACCA's examining team

BPP
LEARNING
MEDIA

ACCA

S T U D Y T E X T

DIPLOMA IN INTERNATIONAL FINANCIAL REPORTING

BPP Learning Media is an **ACCA Approved Learning Partner – content**. This means we work closely with ACCA to ensure this Study Text contains the information you need to pass your exam.

In this Study Text, which has been reviewed by the **ACCA examination team,** we:

- **Include** the revised IFRSs and IASs
- **Discuss** the **best strategies** for studying for your exams
- **Highlight** the **most important elements** in the syllabus and the **key skills** you will need
- **Signpost** how each chapter links to the syllabus and the study guide
- **Provide** lots of **exam focus points** demonstrating what is expected of you in the exam
- **Emphasise key points** in regular **fast forward summaries**
- **Test your knowledge** of what you've studied in **quick quizzes**

FOR EXAMS IN DECEMBER 2014 AND JUNE 2015

BPP
LEARNING MEDIA

Tenth edition October 2014

ISBN 9781 4727 2882 1
Previous ISBN 9781 4453 9960 7
eISBN 9781 4727 3051 0

British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library

Published by

BPP Learning Media Ltd
BPP House, Aldine Place
142–144 Uxbridge Road
London W12 8AA

www.bpp.com/learningmedia

Printed in the United Kingdom by

Ricoh UK Limited
Unit 2
Wells Place
Merstham
RH1 3LG

Your learning materials, published by BPP Learning Media Ltd, are printed on paper obtained from traceable sustainable sources.

We are grateful to the Association of Chartered Certified Accountants for permission to reproduce past examination questions. The suggested solutions in the practice answer bank have been prepared by BPP Learning Media Ltd, unless otherwise stated.

Contents

A note about copyright

Dear Customer

What does the little © mean and why does it matter?

Your market-leading BPP books, course materials and e-learning materials do not write and update themselves. People write them: on their own behalf or as employees of an organisation that invests in this activity. Copyright law protects their livelihoods. It does so by creating rights over the use of the content.

Breach of copyright is a form of theft – as well as being a criminal offence in some jurisdictions, it is potentially a serious breach of professional ethics.

With current technology, things might seem a bit hazy but, basically, without the express permission of BPP Learning Media:

- Photocopying our materials is a breach of copyright
- Scanning, ripcasting or conversion of our digital materials into different file formats, uploading them to Facebook or emailing them to your friends is a breach of copyright

You can, of course, sell your books, in the form in which you have bought them – once you have finished with them. (Is this fair to your fellow students? We update for a reason.) Please note the e-products are sold on a single user licence basis: we do not supply 'unlock' codes to people who have bought them second-hand.

And what about outside the UK? BPP Learning Media strives to make our materials available at prices students can afford by local printing arrangements, pricing policies and partnerships which are clearly listed on our website. A tiny minority ignore this and indulge in criminal activity by illegally photocopying our material or supporting organisations that do. If they act illegally and unethically in one area, can you really trust them?

Learning to Learn Accountancy

BPP's ground-breaking **Learning to Learn Accountancy** book is designed to be used both at the outset of your ACCA studies and throughout the process of learning accountancy. It challenges you to consider how you study and gives you helpful hints about how to approach the various types of paper which you will encounter. It can help you **focus your studies on the subject and exam**, enabling you to **acquire knowledge**, **practise and revise efficiently and effectively**.

Helping you to pass

BPP Learning Media – Approved Learning Partner – content

As ACCA's **Approved Learning Partner – content**, BPP Learning Media gives you the **opportunity** to use study materials reviewed by the ACCA examination team. By incorporating the examination team's comments and suggestions regarding the depth and breadth of syllabus coverage, the BPP Learning Media Study Text provides excellent, **ACCA-approved** support for your studies.

Tackling studying

Studying can be a daunting prospect, particularly when you have lots of other commitments. The **different features** of the text, the **purposes** of which are explained fully on the **Chapter features** page, will help you whilst studying and improve your chances of **exam success**.

Developing exam awareness

Our Texts are completely **focused** on helping you pass your exam.

Our advice on **Studying for the Diploma in International Financial Reporting (Dip IFR)** outlines the **content** of the paper, the **necessary skills** you are expected to be able to demonstrate and any **brought forward knowledge** you are expected to have.

Exam focus points are included within the chapters to highlight when and how specific topics were examined, or how they might be examined in the future.

Using the Syllabus and Study Guide

You can find the syllabus, Study Guide and other useful resources for Dip IFR on the ACCA web site:

http://www.accaglobal.com/uk/en/student/dipifr/dipifr-resources.html

The Study Text covers **all aspects** of the syllabus to ensure you are as fully prepared for the exam as possible.

Testing what you can do

Testing yourself helps you develop the skills you need to pass the exam and also confirms that you can recall what you have learnt.

We include **Questions** – lots of them – both within chapters and in the **Practice Question Bank**, as well as **Quick Quizzes** at the end of each chapter to test your knowledge of the chapter content.

Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list Topic list | Syllabus reference	What you will be studying in this chapter and the relevant section numbers, together with ACCA syllabus references.
Introduction	Puts the chapter content in the context of the syllabus as a whole.
Study Guide	Links the chapter content with ACCA guidance.
Exam Guide	Highlights how examinable the chapter content is likely to be and the ways in which it could be examined.
Knowledge brought forward from earlier studies	What you are assumed to know from previous studies/exams.
FAST FORWARD	Summarises the content of main chapter headings, allowing you to preview and review each section easily.
Examples	Demonstrate how to apply key knowledge and techniques.
Key terms	Definitions of important concepts that can often earn you easy marks in exams.
Exam focus points	When and how specific topics were examined, or how they may be examined in the future.
Question	Give you essential practice of techniques covered in the chapter.
Chapter Roundup	A full list of the Fast Forwards included in the chapter, providing an easy source of review.
Quick Quiz	A quick test of your knowledge of the main topics in the chapter.
Practice Question Bank	Found at the back of the Study Text with more comprehensive chapter questions. Cross referenced for easy navigation.

Studying for the Diploma in International Financial Reporting

Aim

To develop knowledge, understanding and application of International Financial Reporting Standards and the concepts and principles which underpin them.

Objectives

On completion of the Diploma candidates should be able to:

- Understand and explain the structure of the international professional and conceptual framework of accounting
- Apply relevant financial reporting standards to key elements of financial reports
- Identify and apply disclosure requirements for companies relating to the presentation of financial reports and notes
- Prepare group financial statements (excluding statements of cash flows for groups) including subsidiaries, associates and joint ventures

Position of the course within the overall portfolio of ACCA's qualification framework

Dip IFR builds on the technical and/or practical knowledge acquired from recognised country specific accountancy qualifications or relevant work experience. The course introduces the candidate to the wider international framework of accounting and the system of standard setting.

This conversion course concentrates on the application of conceptual and technical financial accounting knowledge that candidates have already obtained to the specific requirements of financial reporting under international professional regulation and standards.

Dip IFR also provides essential international financial reporting knowledge and principles that will prepare candidates for the increasingly global market place and keep them abreast of international developments and how they might apply to companies and businesses.

Dip IFR is intended for professional accountants and auditors working in practice and industry who are qualified in accordance with national accounting standards. Official documentation is required.

The prerequisite knowledge for Dip IFR can come from:

- A relevant degree plus two years' work experience
- Three years' work experience
- ACCA affiliate status
- ACCA Certificate in International Financial Reporting plus two years' work experience

Approach to examining the syllabus

The examination is a three-hour paper. Most questions will contain a mix of computational and discursive elements. Some questions will adopt a scenario/case study approach. All questions are compulsory.

	Number of marks
One 'groups' question	40
Three scenario questions	60
	100

The **first question** will attract 40 marks. It will Involve preparation of one or more of the consolidated financial statements that are examinable within the syllabus. This question will include several issues that will need to be addressed prior to performing the consolidation procedures. Some of these issues may only relate to the financial statements of the parent prior to their consolidation.

This question will require candidates to prepare the consolidated statement of financial position and/or the consolidated statement of comprehensive income and may additionally include possibly the consolidated statement of changes in equity. Questions involving the preparation of the consolidated statement of cash flows will not be set. A key purpose of this question is to assess technical consolidation skills. However, the question will also require candidates to adjust a number of transactions (typically three or four) that have been incorrectly or incompletely accounted for in the financial statements of group entities (usually the parent entity). In order to make these adjustments candidates will need to apply the provisions of relevant IFRSs. In Question 1 the emphasis will be on application rather than explanation.

The other three questions will attract 20 marks each. These will often be related to a scenario in which questions arise regarding the appropriate accounting treatment and or disclosure of a range of issues. In such questions candidates may be expected to comment on management's chosen accounting treatment and determine a more appropriate one, based on circumstances described in the question. Occasionally one of the questions might focus more specifically on the requirements of one specific International Financial Reporting Standard. In all three questions there will be more emphasis on explanation of financial reporting issues than of numerical financial statements preparation.

Question 2 will often present candidates with a scenario or a range of scenarios for which the correct financial reporting treatment is complex or uncertain. Often the question will place the candidate in a 'real-life' role, for example chief accountant reporting to the chief executive officer or senior accountant supervising an assistant. The question frequently requires candidates to address a series of questions that have been posed by the other party in the scenario. The question will often ask candidates to present a reply or report that deals with the appropriate financial reporting of the issues raised in the scenario. The primary skill in this question is identifying and describing the issues, rather than the detailed computation of numbers. However, some marks may be available for numerical calculations.

Question 3 will usually deal with a particular IFRS in some detail. Such a question would require candidates to describe key features of the IFRS and apply it to two or more situations that the question describes. In contrast with Question 1, there will only be a limited number of marks available for technical preparation in such circumstances, the majority of marks being available for identifying and quantifying the appropriate adjustments.

Question 4 will often present candidates with three or four reasonably complex issues and require them to prepare extracts from the financial statements that show the appropriate financial reporting of those issues. This question will usually involve a little more computational work than Question 2. Examples of issues that could be examined in this question include, but are not restricted to, impairment calculations for a cash-generating unit, computation of the cost of a constructed item of property, plant and equipment, and accounting for the decommissioning provision relating to an asset such as a nuclear power station.

Some International Financial Reporting Standards are very detailed and complex. In the Dip IFR exam candidates need to be aware of the principles and key elements of these Standards. Candidates will also be

expected to have an appreciation of the background and need for international accounting and financial reporting and issues related to harmonisation of accounting in a global context.

The overall passmark for the Diploma in International Financial Reporting is 50%.

Additional information

Candidates need to be aware that the exam year will run from 1 September to the following 31 August. The cut off relating to examinable documents will be set 12 months before the start of the year.

Knowledge of the new examinable regulations issued by 31st August will be required in examination sessions being held in the following calendar year. Documents may be examinable even if the effective date is in the future.

The documents listed as being examinable are the latest that were issued prior to 31st August 2013 and will be examinable in the December 2014 and June 2015 examination sessions.

This Study Text is for exams up to and including June 2015.

Syllabus and Study Guide

A International sources of authority

(1) The International Accounting Standards Board (IASB) and the regulatory framework

B Elements of financial statements

(1) Revenue recognition

(2) Property, plant and equipment

(3) Impairment of assets

(4) Leases

(5) Intangible assets and goodwill

(6) Inventories and construction contracts

(7) Financial instruments

(8) Liabilities – provisions, contingent assets and liabilities

(9) Accounting for employment and post-employment benefits

(10) Taxation in financial statements

(11) The effects of changes in foreign currency exchange rates

(12) Agriculture

(13) Share-based payment

(14) Exploration and evaluation expenditures

C Presentation and additional disclosures

(1) Presentation of the statement of financial position, and statement of profit or loss and other comprehensive income

(2) Earnings per share

(3) Events after the reporting date

(4) Accounting policies, changes in accounting estimates and errors

(5) Related party disclosures

(6) Operating segments

(7) Reporting requirements of small and medium-sized entities (SMEs)

D Preparation of external financial reports for combined entities, associates and joint arrangements

(1) Preparation of group consolidated external reports

(2) Business combinations – intra-group adjustments

(3) Business combinations – fair value adjustments

(4) Business combinations – associates and joint arrangements

Excluded topics

The following topics are specifically excluded from the syllabus.

- Partnership and branch financial statements
- Complex group structures including sub-subsidiaries or mixed groups and foreign subsidiaries
- Piece-meal acquisitions, disposal of subsidiaries and group reconstructions
- Financial statements of banks and similar financial institutions
- Preparation of statements of cash flows (single company and consolidated)
- Schemes of reorganisation/reconstruction
- Company/share valuation
- Accounting for insurance entities
- International financial reporting exposure drafts and discussion papers
- The international public sector perspective
- Multi-employer benefit schemes
- Information reflecting the effects of changing prices and financial reporting in hyperinflationary economies
- Share-based payment transactions with cash alternatives

Key areas of the syllabus

The key topic areas are as follows.

- International sources of authority
- Elements of financial statements
- Presentation of accounts and additional disclosures
- Preparation of external reports for combined entities, associates and joint ventures

Wider reading

Wider reading is absolutely essential, especially regular study of relevant articles from ACCA's *Student Accountant*. Of particular relevance are articles written by the Dip IFR examinations team. These are available on the ACCA website in the Dip IFR section:

http://www.accaglobal.com/uk/en/student/dipifr/dipifr-resources/technical-articles.html

Examinable Documents

International Accounting Financial Reporting Standards	
	The Conceptual Framework for Financial Reporting
IAS 1	Presentation of financial statements
IAS 2	Inventories
IAS 8	Accounting policies, changes in accounting estimates and errors
IAS 10	Events after the reporting period
IAS 11	Construction contracts
IAS 12	Income taxes
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effects of changes in foreign exchange rates
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 27	Separate financial statements
IAS 28	Investment in associates
IAS 32	Financial instruments: Presentation
IAS 33	Earnings per share
IAS 34	Interim financial reporting
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 39	Financial instruments: recognition and measurement
IAS 40	Investment property
IAS 41	Agriculture
IFRS 1	First time adoption of International Financial Reporting Standards
IFRS 2	Share-based payment
IFRS 3	Business combinations
IFRS 5	Non-current assets held for sale and discontinued operations
IFRS 6	Exploration for and evaluation of mineral resources
IFRS 7	Financial instruments: disclosures
IFRS 8	Operating segments
IFRS 9	Financial instruments
IFRS 10	Consolidated financial statements

International Accounting Financial Reporting Standards	
IFRS 11	Joint arrangements
IFRS 12	Disclosure of interests in other entities
IFRS 13	Fair value measurement

Study Guide

A INTERNATIONAL SOURCES OF AUTHORITY

1. The International Accounting Standards Board (IASB) and the regulatory framework

- Discuss the need for international accounting standards and possible barriers to their development
- Explain the structure and constitution of the IASB and the standard setting process
- Understand and interpret the Financial Reporting Framework
- Progress towards international harmonisation
- Account for the first-time adoption of International Financial Reporting Standards.

B ELEMENTS OF FINANCIAL STATEMENTS

1. Revenue recognition

- Outline the principles of the timing of revenue recognition
- Explain the concept of substance over form in relation to recognising sales revenue
- Discuss the various points in the production and sales cycle where it may, depending on circumstances, be appropriate to recognise gains and losses – give examples of this
- Describe the IASB's approach to revenue recognition.

2. Property, plant and equipment

- Define the initial cost of a non-current asset (including a self-constructed asset) and apply this to various examples of expenditure, distinguishing between capital and revenue items
- Identify pre-conditions for the capitalisation of borrowing costs
- Describe, and be able to identify, subsequent expenditures that should be capitalised
- State and appraise the effects of the IASB's rules for the revaluation of property, plant and equipment
- Account for gains and losses on the disposal of re-valued assets
- Calculate depreciation on:
  - Revalued assets, and
  - Assets that have two or more major items or significant parts
- Apply the provisions of accounting standards relating to government grants and government assistance
- Describe the criteria that need to be present before non-current assets are classified as held for sale, either individually or in a disposal group
- Account for non-current assets and disposal groups that are held for sale
- Discuss the way in which the treatment of investment properties differs from other properties
- Apply the requirements of international accounting standards to investment properties.

3. Impairment of assets

- Define the recoverable amount of an asset; define impairment losses
- Give examples of, and be able to identify, circumstances that may indicate that an impairment of an asset has occurred
- Describe what is meant by a cash-generating unit
- State the basis on which impairment losses should be allocated, and allocate a given impairment loss to the assets of a cash-generating unit.

4. Leases

- Define the essential characteristics of a lease
- Describe and apply the method of determining a lease type (ie an operating or finance lease)

- Explain the effect on the financial statements of a finance lease being incorrectly treated as an operating lease
- Account for operating leases in the financial statements of the lessor and the lessee
- Account for finance leases in the financial statements of the lessor and lessee
- Outline the principles of accounting standards for leases and the main disclosure requirements. Note: the net cash investment method will not be examined.

5. Intangible assets and goodwill

- Discuss the nature and possible accounting treatments of both internally generated and purchased goodwill
- Distinguish between goodwill and other intangible assets
- Define the criteria for the initial recognition and measurement of intangible assets
- Explain the subsequent accounting treatment, including the principle of impairment tests in relation to purchased goodwill
- Identify the circumstances in which negative goodwill arises, and its subsequent accounting treatment
- Describe and apply the requirements of international accounting standards to internally generated assets other than goodwill (eg research and development)
- Describe the method of accounting specified by the IASB for the exploration for and evaluation of mineral resources.

6. Inventories and construction contracts

- Measure and value inventories
- Define a construction contract and describe why recognising profit before completion is generally considered to be desirable; discuss if this may be profit smoothing
- Describe the ways in which contract revenue and contract cost may be recognised
- Calculate and disclose the amounts to be shown in the financial statements for construction contracts.

7. Financial instruments

- Account for debt instruments, equity instruments and the allocation of finance costs
- Account for fixed interest rate and convertible bonds
- Discuss the definition and classification of a financial instrument
- Discuss the measurement issues relating to financial instruments
- Explain the measurement requirements for financial instruments including the use of current values, hedging and the treatment of gains and losses
- Describe the nature of the presentation and disclosure requirements relating to financial instruments
- Discuss the key areas where consensus is required on the accounting treatment of financial instruments.

8. Liabilities – provisions, contingent assets and liabilities

- Explain why an accounting standard on provisions is necessary – give examples of previous abuses in this area
- Define provisions, legal and constructive obligations, past events and the transfer of economic benefits
- State when provisions may and may not be made, and how they should be accounted for
- Explain how provisions should be measured
- Define contingent assets and liabilities – give examples and describe their accounting treatment
- Identify and account for:
  - Onerous contracts
  - Environmental and similar provisions
- Discuss the validity of making provisions for future repairs or renewals.

9. Accounting for employment and post-employment benefit costs

- Describe the nature of defined contribution, multi-employers and defined benefits schemes
- Explain the recognition and measurement of defined benefit schemes under current proposals
- Account for defined benefit schemes including the amounts shown in the financial statements (and notes to the accounts).

10. Taxation in financial statements

- Account for current tax liabilities and assets in accordance with international accounting standards
- Describe the general principles of government sales taxes (eg VAT or GST)
- Explain the effect of taxable temporary differences on accounting and taxable profits
- Outline the principles of accounting for deferred tax
- Identify and account for the IASB requirements relating to deferred tax assets and liabilities
- Calculate and record deferred tax amounts in the financial statements.

11. The effects of changes in foreign currency exchange rates

- Discuss the recording of transactions and translation of monetary/non-monetary items at the reporting date for individual entities in accordance with relevant accounting standards
- Distinguish between reporting and functional currencies
- Determine an entity's functional currency.

12. Agriculture

- Recognise the scope of international accounting standards for agriculture
- Discuss the recognition and measurement criteria including the treatment of gains and losses, and the inability to measure fair value reliably
- Identify and explain the treatment of government grants, and the presentation and disclosure of information relating to agriculture
- Report on the transformation of biological assets and agricultural produce at the point of harvest and account for agriculture related government grants.

13. Share-based payment

- Understand the term 'share-based payment'
- Discuss the key issue that measurement of the transaction should be based on fair value
- Explain the difference between cash settled share based payment transactions and equity settled share based payment transactions
- Identify the principles applied to measuring both cash and equity settled share-based payment transactions
- Compute the amounts that need to be recorded in the financial statements when an entity carries out a transaction where the payment is share based.

14. Exploration and evaluation expenditures

- Outline the need for an accounting standard in this area and clarify its scope
- Give examples of elements of cost that might be included in the initial measurement of exploration and evaluation assets
- Describe how exploration and evaluation assets should be classified and reclassified
- Explain when and how exploration and evaluation assets should be tested for impairment

C PRESENTATION OF ACCOUNTS AND ADDITIONAL DISCLOSURES

1. Presentation of the statement of financial position, and statement of profit or loss and other comprehensive income

- State the objectives of international accounting standards governing presentation of financial statements
- Describe the structure and content of statements of financial position, statements of profit or loss and other comprehensive income including continuing operations
- Discuss the importance of identifying and reporting the results of discontinued operations
- Define and account for non-current assets held for sale and discontinued operations
- Discuss 'fair presentation' and the accounting concepts/principles
- Recognise the content and format of interim financial statements.

2. Earnings per share

- Recognise the importance of comparability in relation to the calculation of earnings per share (EPS) and its importance as a stock market indicator
- Explain why the trend of EPS may be a more accurate indicator of performance than a company's profit trend
- Define earnings
- Calculate the EPS in the following circumstances:
  - Basic EPS
  - Where there has been a bonus issue of shares/stock split during the year, and
  - Where there has been a rights issue of shares during the year
- Explain the relevance to existing shareholders of the diluted EPS, and describe the circumstances that will give rise to a future dilution of the EPS
- Compute the diluted EPS in the following circumstances:
  - Where convertible debt or preference shares are in issue
  - Where share options and warrants exist
- Identify anti-dilutive circumstances.

3. Events after the reporting date

- Distinguish between and account for adjusting and non-adjusting events after the reporting date

4. Accounting policies, changes in accounting estimates and errors

- Identify items requiring separate disclosure, including their accounting treatment and required disclosures.
- Recognise the circumstances where a change in accounting policy is justified
- Define prior period adjustments and errors and account for the correction of errors and changes in accounting policies.

5. Related party disclosures

- Define and apply the definition of related parties in accordance with international accounting standards
- Describe the potential to mislead users when related party transactions are accounted for
- Explain the disclosure requirements for related party transactions.

6. Operating segments

- Discuss the usefulness and problems associated with the provision of segment information
- Define an operating segment
- Identify reportable segments (including applying the aggregation criteria and quantitative thresholds).

7. Reporting requirements of small and medium-sized entities (SMEs)

- Outline the principal considerations in developing a set of accounting standards for SMEs

- Discuss solutions to the problem of differential financial reporting
- Discuss the reasons why the IFRS for SMEs does not address certain topics.

D PREPARATION OF EXTERNAL REPORTS FOR COMBINED ENTITIES AND JOINT VENTURES

1. Preparation of group consolidated external reports

- Explain the concept of a group and the purpose of preparing consolidated financial statements
- Explain and apply the definition of subsidiary companies
- Identify the circumstances and reasoning when subsidiaries should be excluded from consolidated financial statements
- Prepare a consolidated statement of financial position for a simple group dealing with pre and post acquisition profits, non-controlling interests and goodwill
- Explain the need for using coterminous year-ends and uniform accounting polices when preparing consolidated financial statements and describe how it is achieved in practice
- Prepare a consolidated statement of profit or loss, statement of statement of profit or loss and other comprehensive income and statement of changes in equity for a simple group, including an example where an acquisition occurs during the year where there is a non-controlling interest.

2. Business combinations – intra-group adjustments

- Explain why intra-group transactions should be eliminated on consolidation
- Report the effects of intra-group trading and other transactions including:
  - Unrealised profits in inventory and non-current assets
  - Intra-group loans and interest and other intra-group charges, and
  - Intra-group dividends.

3. Business combinations – fair value adjustments

- Explain why it is necessary for both the consideration paid for a subsidiary and the subsidiary's identifiable assets and liabilities to be accounted for at their fair values when preparing consolidated financial statements
- Prepare consolidated financial statements dealing with fair value adjustments (including their effect on consolidated goodwill) in respect of:
  - Depreciating and non-depreciating non- current assets
  - Inventory
  - Monetary liabilities
  - Assets and liabilities (including contingencies), not included in the subsidiary's own statement of financial position.

4. Business combinations – associates and joint ventures

- Define associates and joint ventures (ie jointly controlled operations, assets and entities)
- Prepare consolidated financial statements to include a single subsidiary and an associated company or a joint venture.

Analysis of past papers

The analysis below shows the elements of the syllabus which have been examined so far under the current paper including the pilot paper. Further details can be found in the exam focus points in the relevant chapters.

Covered in Text chapter		Dec 13	Jun 13	Dec 12	Jun 12	Dec 11	Jun 11	Dec 10	Pilot Paper 10	Jun 10	Dec 09	Jun 09	Dec 08	Jun 08	Dec 07	Jun 07	Dec 06
	International sources of authority																
1	The IASB and the regulatory framework					✓		✓									
2	Conceptual framework for financial reporting																
	Elements of financial statements																
3	Revenue recognition		✓✓	✓✓				✓		✓✓	✓	✓	✓	✓	✓	✓	
4 and 5	Accounting for tangible non-current assets	✓✓ ✓	✓	✓	✓✓	✓	✓	✓✓ ✓	✓	✓✓ ✓	✓✓ ✓	✓✓	✓	✓	✓✓	✓	✓
6	Accounting for leases			✓	✓		✓	✓✓ ✓	✓✓	✓	✓✓	✓✓	✓	✓	✓	✓	
7	Intangible non-current assets and goodwill	✓			✓	✓	✓✓ ✓		✓	✓			✓	✓✓	✓✓	✓	✓
8	Inventories and construction contracts	✓				✓		✓		✓	✓	✓✓	✓		✓		✓
9	Liabilities - provisions, contingent assets and liabilities		✓	✓	✓	✓	✓✓	✓	✓✓		✓✓	✓✓	✓✓	✓✓	✓	✓	✓
10	Employee benefits				✓✓	✓						✓					✓
11	Financial instruments	✓✓	✓	✓✓			✓✓ ✓	✓✓	✓✓✓	✓	✓	✓	✓	✓	✓		✓
12	Accounting for taxation	✓			✓	✓		✓✓		✓✓	✓✓ ✓	✓			✓✓		✓✓
13	Foreign currency translation		✓		✓				✓	✓				✓			
14	Accounting for agriculture and mineral resources												✓	✓			
15	Share-based payment	✓	✓	✓	✓		✓	✓✓	✓		✓				✓	✓	
	Presentation and additional disclosures																
16	Presentation of published financial statements										✓	✓	✓	✓	✓	✓	✓
17	Reporting financial performance			✓	✓✓				✓		✓✓	✓	✓	✓			
18	Earnings per share							✓✓									
19	Miscellaneous standards: related party disclosures and segment reporting	✓	✓									✓					
20	Reporting for small and medium-sized entities												✓				
	Financial reports for combined entities and joint arrangements																
21	Constitution of a group	✓	✓✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
22	The consolidated statement of financial position	✓	✓		✓	✓		✓		✓			✓		✓	✓	
23	The consolidated statement of profit or loss			✓			✓		✓		✓	✓		✓			✓
24	Accounting for associates		✓		✓	✓	✓			✓		✓		✓			
25	Accounting for joint arrangements	✓	✓	✓				✓									
26	Current developments		✓														

PART A

International sources of authority

1

The IASB and the regulatory framework

Topic list	Syllabus reference
1 The need for a regulatory framework	A1
2 International Accounting Standards Board (IASB)	A1
3 Other international influences	A1
4 Scope and application of IFRSs	A1
5 Progress towards global harmonisation	A1
6 Feedback on the IASB	A1
7 IFRS 1: First-time adoption of International Financial Reporting Standards	A1

Introduction

In this chapter we are concerned with the IASB's relationship with other bodies, with the way it operates and how IFRSs are produced.

Later in this text we look at some of the theory behind what appears in the accounts. The most important document in this area is the IASB's *Conceptual Framework for Financial Reporting (*previously the *Framework for the preparation and presentation of financial statements)*. Since it was published, all IFRSs have been based on the principles it contains.

Study guide

A	**INTERNATIONAL SOURCES OF AUTHORITY**
A1	**The International Accounting Standards Board and the regulatory framework**
(a)	Discuss the need for international financial reporting standards and possible barriers to this process
(b)	Explain the structure and constitution of the IASB and the standard setting process
(c)	Progress towards international harmonisation
(d)	Account for the first-time adoption of International Financial Reporting Standards

1 The need for a regulatory framework

1.1 Introduction

The regulatory framework is the most important element in ensuring relevant and faithfully presented financial information and thus meeting the needs of shareholders and other users.

Without a single body overall responsible for producing financial reporting standards (the IASB) and a framework of general principles within which they can be produced (the *Conceptual Framework*), there would be no means of enforcing compliance with accounting regulations. Also, accounting regulations would be unable to evolve in any structured way in response to changes in economic conditions.

1.2 Principles-based versus rules-based systems

FAST FORWARD

A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.

The *Conceptual Framework*, which is discussed in more detail in the following chapter, provides the background of principles within which standards can be developed. This system is intended to ensure that standards are not produced which are in conflict with each other and also that any departure from a standard can be judged on the basis of whether or not it is in keeping with the principles set out in the *Conceptual Framework*. This is a **principles-based** system.

In the absence of a reporting framework, a more **rules-based** approach has to be adopted. This leads to a large mass of regulation designed to cover every eventuality, as in the US. As we have seen over the past few years, a large volume of regulatory measures does not always detect or prevent financial irregularity. One presumed advantage of rules-based systems is that the exercise of judgement is minimised. Auditors who fear litigation tend to prefer rules-based systems. It could be that a rules-based approach is appropriate for controversial areas in accounting.

1.3 Impact of globalisation

FAST FORWARD

The need for harmonised financial reporting standards arises as a result of the globalisation of business activities and operations. Harmonised financial reporting standards are intended to provide:

- A platform for wider investment choice
- A more efficient capital market
- Lower cost of capital
- Enhanced business development

The current reality is that the world's **capital markets operate** more and more freely **across borders**. The impacts of rapid globalisation are encapsulated by the words of Paul Volker, Chairman of the IFRS Foundation Trustees in November 2002, in a speech to the World Congress of Accountants.

'Developments over the past year and more have strongly reinforced the logic of achieving and implementing high-quality international accounting standards. In an age when capital flows freely across borders, it simply makes sense to account for economic transactions, whether they occur in the Americas, Asia, or Europe, in the same manner. Providing improved transparency and comparability will certainly help ensure that capital is allocated efficiently. Not so incidentally, generally accepted international standards will reduce the cost of compliance with multiple national standards.'

As the modern business imperative moves towards the globalisation of operations and activities, there is an underlying commercial logic that also requires a **truly global capital market.** Harmonised financial reporting standards are intended to provide:

- A platform for wider investment choice
- A more efficient capital market
- Lower cost of capital
- Enhanced business development

Globally, users of financial statements need **transparent** and **comparative information** to help them **make economic decisions**.

Since 2005 EU listed companies have been required to use IFRSs to prepare their consolidated financial statements. This is an important step towards eventual harmonisation.

Exam focus point

A question in the December 2011 paper covered the implications to an international organisation of switching to IFRS. The June 2004 paper required candidates to discuss lack of commonality between IFRSs and the requirements of securities exchanges in USA and Japan.

2 The International Accounting Standards Board (IASB)

FAST FORWARD

The organisational structure consists of:

- The IFRS Foundation
- The IASB
- The IFRS Advisory Council
- The IFRS Interpretations Committee

2.1 Introduction

The International Accounting Standards Board is an independent, privately-funded accounting standard setter based in London.

In March 2001 the IASC Foundation was formed as a not-for-profit corporation incorporated in the USA. The IASC Foundation is the parent entity of the IASB. In July 2010 it changed its name to the IFRS Foundation.

From April 2001 the IASB assumed accounting standard setting responsibilities from its predecessor body, the International Accounting Standards Committee (IASC). This restructuring was based upon the recommendations made in the *Recommendations on Shaping IASC for the Future.*

2.2 How the IASB is made up

The 15 members of the IASB come from nine countries and have a variety of backgrounds with a mix of auditors, preparers of financial statements, users of financial statements and an academic. The Board consists of 12 full-time members and two part-time members.

2.3 Objectives of the IASB

The formal objectives of the IASB, formulated in its mission statement are:

(a) To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in general purpose financial statements

(b) To promote the use and vigorous application of those standards

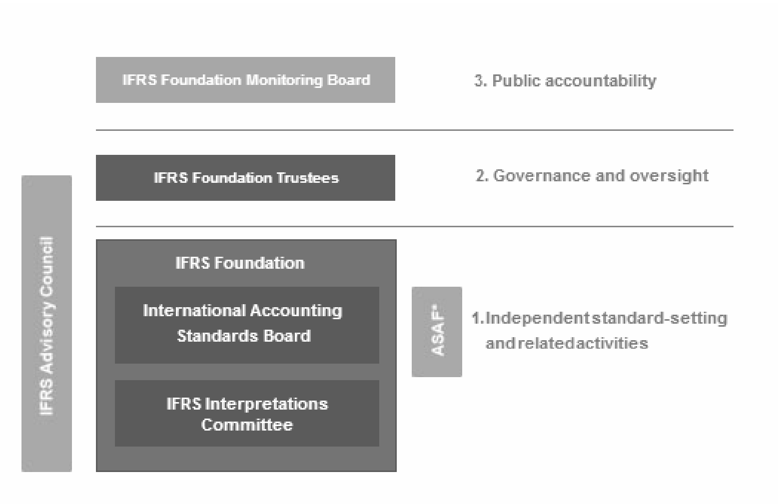
(c) To work actively with national accounting standard setters to bring about convergence of national accounting standards and IFRS to high quality solutions.

Exam focus point

Knowledge of the objectives of the IFRS Foundation is important so as to provide you with the background to IFRS.

2.4 Structure of the IASB

The structure is as follows.



Source: http://www.ifrs.org/About-us/Pages/How-we-are-structured.aspx

Trustees. The Trustees comprise a group of individuals with diverse geographic and functional backgrounds. The Trustees appoint the Members of the Board, the IFRS Interpretations Committee and the IFRS Advisory Council. In addition to monitoring the Foundation's effectiveness and raising its funds, the Trustees will approve the budget and have responsibility for constitutional changes. Trustees were appointed so that initially there were six from North America, six from Europe, four from Asia Pacific, and three others from any area, as long as geographic balance is maintained. Trustees were selected as follows:

(a) The International Federation of Accountants (IFAC) suggested candidates to fill five of the nineteen Trustee seats and international organisations of preparers, users and academics each suggested one candidate.

(b) The remaining Trustees are 'at-large' in that they were not selected through the constituency nomination process.

IFRS Advisory Council. The IFRS Advisory Council provides a formal vehicle for further groups and individuals with diverse geographic and functional backgrounds to give advice to the Board and, at times, to advise the Trustees. It comprises about fifty members and meets at least three times a year. It is consulted by the IASB on all major projects and its meetings are open to the public. It advises the IASB on prioritisation of its work and on the implications of proposed standards for users and preparers of financial statements.

IFRS Interpretations Committee. The Interpretation Committee provides timely guidance on the application and interpretation of International Financial Reporting Standards. It deals with newly identified financial reporting issues not specifically addressed in IFRSs, or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.

2.5 IFRS-advantages and disadvantages

The advantages and disadvantages of adopting IFRS have to be considered by each adopting country and are being widely debated in the US at the moment.

The main advantages are seen to be:

- A business can present its financial statements on the same basis as its foreign competitors, making comparison easier.
- Cross-border listing will be facilitated, making it easier to raise capital abroad.
- Companies with foreign subsidiaries will have a common, company-wide accounting language.
- Foreign companies which are targets for takeovers or mergers can be more easily appraised.

The disadvantages are perceived to be:

- The cost of implementing IFRS
- The belief by some that there is a lower level of detail in IFRS (compared with US GAAP).

Countries which have national standards which are very prescriptive are worried about the principles-based standards in IFRS which require the application of judgement. This is particularly so in the US. US accountants are subject to a high degree of litigation and their defence in court is usually that they complied with the relevant sub-section of one of the hundreds of detailed standards which make up US GAAP. They fear that adoption of IFRS will remove this defence.

Question — Harmonisation

In accounting terms what do you think are:

(a) The advantages to international harmonisation?
(b) The barriers to international harmonisation?

Answer

(a) *Advantages of global harmonisation*

The advantages of harmonisation will be based on the benefits to users and preparers of accounts, as follows.

(i) Investors, both individual and corporate, would like to be able to compare the financial results of different companies internationally as well as nationally in making investment decisions.

(ii) Multinational companies would benefit from harmonisation for many reasons including the following.

(1) Better access would be gained to foreign investor funds.
(2) Management control would be improved, because harmonisation would aid internal communication of financial information.
(3) Appraisal of foreign entities for take-overs and mergers would be more straightforward.
(4) It would be easier to comply with the reporting requirements of overseas stock exchanges.
(5) Preparation of group accounts would be easier.
(6) A reduction in audit costs might be achieved.
(7) Transfer of accounting staff across national borders would be easier.

(iii) Governments of developing countries would save time and money if they could adopt international standards and, if these were used internally, governments of developing countries could attempt to control the activities of foreign multinational companies in their

own country. These companies could not 'hide' behind foreign accounting practices which are difficult to understand.

(iv) Tax authorities. It will be easier to calculate the tax liability of investors, including multinationals who receive income from overseas sources.

(v) Regional economic groups usually promote trade within a specific geographical region. This would be aided by common accounting practices within the region.

(vi) Large international accounting firms would benefit as accounting and auditing would be much easier if similar accounting practices existed throughout the world.

(b) *Barriers to harmonisation*

(i) Different purposes of financial reporting. In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.

(ii) Different legal systems. These prevent the development of certain accounting practices and restrict the options available.

(iii) Different user groups. Countries have different ideas about who the relevant user groups are and their respective importance. In the USA investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.

(iv) Needs of developing countries. Developing countries are obviously behind in the standard setting process and they need to develop the basic standards and principles already in place in most developed countries.

(v) Nationalism is demonstrated in an unwillingness to accept another country's standard.

(vi) Cultural differences result in objectives for accounting systems differing from country to country.

(vii) Unique circumstances. Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example hyperinflation, civil war, currency restriction and so on.

(viii) The lack of strong accountancy bodies. Many countries do not have strong independent accountancy or business bodies which would press for better standards and greater harmonisation.

2.6 The IASB and current accounting standards

The IASB's predecessor body, the IASC, had issued 41 International Accounting Standards (IASs) and on 1 April 2001 the IASB adopted all of these standards and now issues its own International Financial Reporting Standards (IFRSs). So far fourteen new IFRSs have been issued.

2.7 The IASB and FASB

The IASB is currently involved in a joint project with the FASB (Financial Accounting Standards Board – the body responsible for setting accounting standards in the USA) to develop a common conceptual framework. This would provide a sound foundation for developing future accounting standards. The aim is that future standards should be principles-based and internationally-converged. This represents a movement away from the rules-based approach which has characterised US accounting standards.

The new framework will build upon the existing IASB and FASB frameworks and take into account subsequent developments.

2.8 European Commission and IFRSs

All listed entities in member states have been required to use IFRSs in their consolidated financial statements since 2005.

To this end the IASB undertook **improvements projects**, dealing with **revisions to IFRS**, for example in the area of materiality, presentation, leases, related parties and earnings per share. This has been matched in, for example, the UK, by a **convergence project**, bringing UK GAAP into line with IFRSs where these are better.

3 Other international influences

FAST FORWARD

The EC, the UN, the IFAC, the OECD and the FASB all influence the harmonisation process.

Exam focus point

This section is very much background. There may be one or two points you may be able to use in a question on a topic for example, such as, harmonisation.

The role of the EC and IOSCO is also useful background knowledge.

3.1 Other international influences

There are a few **other international bodies** worth mentioning. You are not required to follow their workings in detail, but knowledge of them will aid your studies and should help your general reading around the subject area.

3.1.1 IASB and the EC/intergovernmental bodies

The European Commission has acknowledged the role of the IASB in harmonising world-wide accounting rules and EC representatives attend IASB Board meetings and have joined Steering Committees involved in setting IFRSs. This should bring to an end the idea of a separate layer of European reporting rules.

The EC has also set up a committee to investigate where there are conflicts between EU norms and international standards so that compatibility can be achieved. In turn, the IASB has used EC directives in its work.

The IASB also works closely with the United Nations Working Groups of Experts on International Standards of Accounting and Reporting (UN IASR group), and with the Working Group in Accounting Standards of the Organisation for Economic Co-operation and Development (OECD Working group). These bodies support harmonisation and improvement of financial reporting, but they are not standard-setting bodies and much of their output draws on the work of the IASB (eg using the IASB's *Framework* document).

3.1.2 United Nations (UN)

The UN has a Commission and Centre on Transnational Reporting Corporations through which it gathers information concerning the activities and reporting of multinational companies. The UN processes are highly **political** and probably reflect the attitudes of the governments of developing countries to multinationals. For example, there is an inter-governmental working group of 'experts' on international standards of accounting and reporting which is dominated by the developing countries.

3.1.3 International Federation of Accountants (IFAC)

The IFAC is a private sector body established in 1977 and which now consists of over 100 professional accounting bodies from around 80 different countries. The IFAC's main objective is to co-ordinate the accounting profession on a global scale by issuing and establishing international standards on auditing, management accounting, ethics, education and training. You are already familiar with the **International Standards on Auditing** produced by the IAASB, an IFAC body. The IFAC has separate committees working on these topics and also organises the World Congress of Accountants, which is held every five years. The IASB is affiliated with IFAC.

3.1.4 Organisation for Economic Co-operation and Development (OECD)

The OECD was established in 1960 by the governments of 21 countries to 'achieve the highest sustainable economic growth and employment and a rising standard of living in member countries while maintaining financial stability and, thus, to contribute to the world economy'. The OECD supports the work of the IASB but also undertakes its own **own research** into accounting standards via *ad hoc* working groups. For example, in 1976 the OECD issued guidelines for multinational companies on financial reporting and non-financial

disclosures. The OECD appears to work on behalf of developed countries to protect them from the extreme proposals of the UN.

3.1.5 International Organisation of Securities Commissions (IOSCO)

IOSCO represents the world's securities markets regulators and has worked closely with the IASB on the development of standards. In 2000 it recommended to all its members that they allow multinational users to submit financial statements based on IFRS.

4 Scope and application of IFRSs

4.1 Setting of International Financial Reporting Standards

FAST FORWARD

IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.

4.2 Due process

The overall agenda of the IASB will initially be set by discussion with the IFRS Advisory Council. The process for developing an individual standard would involve the following steps.

Step 1 During the early stages of a project, the IASB may establish an **Advisory Committee** to give advice on issues arising in the project. Consultation with the Advisory Committee and the IFRS Advisory Council occurs throughout the project.

Step 2 IASB may develop and publish **Discussion Papers** for public comment.

Step 3 Following the receipt and review of comments, the IASB would develop and publish an **Exposure Draft** for public comment.

Step 4 Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

The period of exposure for public comment is normally 90 days. However, in exceptional circumstances, proposals may be issued with a comment period of 60 days. Draft IFRS Interpretations are exposed for a 60 day comment period.

4.3 Co-ordination with national standard setters

Close co-ordination between IASB due process and due process of national standard setters is important to the success of the IASB's mandate.

The IASB is exploring ways in which to integrate its due process more closely with national due process. Such integration may grow as the relationship between the IASB and national standard setters evolves. In particular, the IASB is exploring the following procedure for projects that have international implications.

(a) IASB and national standard setters would co-ordinate their work plans so that when the IASB starts a project, national standard setters would also add it to their own work plans so that they can play a full part in developing international consensus. Similarly, where national standard setters start projects, the IASB would consider whether it needs to develop a new Standard or review its existing Standards. Over a reasonable period, the IASB and national standard setters should aim to review all standards where significant differences currently exist, giving priority to the areas where the differences are greatest.

(b) National standards setters would not be required to vote for the IASB's preferred solution in their national standards, since each country remains free to adopt IASB standards with amendments or to adopt other standards. However, the existence of an international consensus is clearly one factor that members of national standard setters would consider when they decide how to vote on national standards.

(c) The IASB would continue to publish its own Exposure Drafts and other documents for public comment.

(d) National standard setters would publish their own exposure document at approximately the same time as IASB Exposure Drafts and would seek specific comments on any significant divergences between the two exposure documents. In some instances, national standard setters may include in their exposure documents specific comments on issues of particular relevance to their country or include more detailed guidance than is included in the corresponding IASB document.

(e) National standard setters would follow their own full due process, which they would ideally choose to integrate with the IASB's due process. This integration would avoid unnecessary delays in completing standards and would also minimise the likelihood of unnecessary differences between the standards that result.

4.4 IASB liaison members

Seven of the full-time members of the IASB have formal liaison responsibilities with national standard setters in order to promote the convergence of national accounting standards and International Financial Reporting Standards. The IASB envisages a partnership between the IASB and these national standard setters as they work together to achieve convergence of accounting standards world-wide.

In addition all IASB members have contact responsibility with national standards setters not having liaison members and many countries are also represented on the IFRS Advisory Council.

4.5 Scope

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are **not intended to be applied to immaterial items, nor are they retrospective**. Each individual IFRS lays out its scope at the beginning of the standard.

4.5.1 Application

Within each individual country **local regulations** govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country concerned.

The IASB **concentrated on essentials** when producing IFRSs. They tried not to make IFRSs too complex, because otherwise they would be impossible to apply on a worldwide basis.

IFRSs/IASs do not override local regulations on financial statements. Financial statements prepared in accordance with IFRS should simply disclose the fact where IFRSs/IASs are complied with in all material respects. Members of the IASB in individual counties will attempt to persuade local authorities, where current regulations deviate from IFRSs/IASs, that the benefits of harmonisation make local change worthwhile.

The following is our **brief summary** of the main points.

- It is difficult if not impossible to comply with both local regulations /statutes as well as IFRS/IAS.
- In the past the regulatory bodies have either amended their standards and/or lobbied for changes in the regulations/statutes.
- Financial statements do not comply with the requirements of IAS, as per IAS 1, unless all IFRSs/IASs are complied with
- It is not appropriate to try to rectify non-compliance by resorting to disclosure or explanatory material.
- A pragmatic and practical response may be to prepare two sets of financial statements
  - Set 1 For local filing purposes and complying with local regulations
  - Set 2 For international publication purposes and complying with IASs/IFRSs.

Note. The company might also resort to the fair presentation override.

4.6 Interpretation of IFRSs/IASs

The IFRS Interpretations Committee assists the IASB by improving existing Standards. It was established in July 2010, and replaced the IFRIC (International Financial Reporting Interpretations Committee), which had itself replaced the Standing Interpretations Committee (SIC) in 2002.

The IFRS Interpretations Committee has two main responsibilities:

- Review, on a timely basis, newly identified financial reporting issues not specifically addressed in IFRSs
- Clarify issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching a consensus on the appropriate treatment.

The IFRS Interpretations Committee also helps the IASB move towards international harmonisation by working with its equivalent national-level bodies (such as the UITF in the UK).

The IFRS Interpretations Committee, like the IASB itself, adopts a **principle-based approach**. Its intention is to provide guidance that is in line with the rest of the IFRSs. It therefore bases itself, like each of the individual Standards, first and foremost on the IASB *Framework*. It will then look at any relevant IFRSs/IASs for principles applying the *Conceptual Framework* to that particular area. It is absolutely essential to the work of the IFRS Interpretations Committee that its interpretations are in line with IASB *Framework* principles, rather than any other accounting principles.

The IFRS Interpretations Committee then in turn informs the IASB of any inadequacies that it finds in the *Conceptual Framework* or in existing IFRSs. If it believes that they should be modified or that a new Standard should be developed, the IFRS Interpretations Committee informs the IASB so that it can consider whether or not to do so. This helps to ensure that the *Conceptual Framework* and existing IFRSs are kept up to date for the actual financial reporting issues that the IFRS Interpretations Committee has found with them.

The IFRS Interpretations Committee develops its interpretations through a due process of consultation and debate which includes making Draft Interpretations available for public comment. The IFRS Interpretations Committee's Interpretations that it makes publicly available are the consensus views that it has reached as a result of this process.

Exam focus point

The role of the IFRS Interpretations Committee is another area which could form the basis of a small question.

4.6.1 Authority and application of IFRS Interpretations Committee Interpretations

IFRS Interpretations Committee Interpretations carry the same authority as IFRSs, in the sense that they set out consensus views that entities must adhere to if they describe their financial statements as being prepared in accordance with IFRS.

IFRS Interpretations Committee Interpretations are applicable from the date of issue or if they specify one, from their effective date. Some Interpretations may contain 'transitional provisions' that apply to their first application.

An Interpretation then ceases to apply when it is overridden by a new IFRS (or other authoritative IASB document). When this happens, this would be mentioned in the Exposure Draft of the new, overriding IFRS (or other document). The IASB would then inform the IFRS Interpretations Committee when this happens.

4.7 IFRS Interpretations Committee due process

Interpretations of IFRS are developed through an international due process that involves accountants, financial analysts and other users of financial statements, the business community, stock exchanges, regulatory and legal authorities, academics and other interested individuals and organisations from around the world. The **IFRS Interpretations Committee discusses technical matters in meetings that are open to public observation**. The due process for each project normally, but not necessarily, involves the

following steps (the steps that are required under the terms of the Constitution are indicated by an asterisk*):

(a) Staff work to identify and review all the issues associated with the topic and to consider the application of the IASB's *Conceptual Framework* to the issues

(b) Study of national accounting requirements and practice and an exchange of views about the issues with national standard setters, including national committees that have responsibility for interpretations of national standards

(c) Publication of a draft Interpretation for public comment if no more than three of the IFRS Interpretations Committee's members have voted against the proposal *

(d) Consideration of all comments received on a draft Interpretation within a reasonable period of time *

(e) Approval by the IFRS Interpretations Committee of an Interpretation if no more than three of the IFRS Interpretations Committee's members have voted against the Interpretation after considering public comments on the draft Interpretation

(f) Approval of the Interpretation by at least eight votes of the Board

5 Progress towards global harmonisation

Exam focus point

Harmonisation is always a hot topic and could come up in your exam as a small discursive question.

You should try to keep up to date by reading publications such as the Financial Times, the Economist and articles posted on the ACCA website.

Close co-ordination between IASB due process and due process of national standard setters is important to the success of the IASB's mandate.

The IASB is exploring ways of further integrating its due process with that of national standard setters. This integration may grow as the relationship between IASB and national standard setters evolves. In particular, the IASB is exploring the following procedure for projects that have international implications.

(a) IASB and national standard setters would co-ordinate their work plans so that when the IASB starts a project, national standard setters would also add it to their own work plans so that they can play a full part in developing international consensus. Similarly, where national standard setters start projects, the IASB would consider whether it needs to develop a new standard or review its existing standards. Over a reasonable period, the IASB and national standard setters should aim to review all standards where significant differences currently exist, giving priority to the areas where the differences are greatest.

(b) National standards setters would not be required to vote for IASB's preferred solution in their national standards, since each country remains free to adopt IASB standards with amendments or to adopt other standards. However, the existence of an international consensus is clearly one factor that members of national standard setters would consider when they decide how to vote on national standards.

(c) The IASB would continue to publish its own Exposure Drafts and other documents for public comment.

(d) National standard setters would publish their own exposure document at approximately the same time as IASB Exposure Drafts and would seek specific comments on any significant divergences between the two exposure documents. In some instances, national standard setters may include in their exposure documents specific comments on issues of particular relevance to their country or include more detailed guidance than is included in the corresponding IASB document.

(e) National standard setters would follow their own full due process, which they would ideally choose to integrate with the IASB's due process. This integration would avoid unnecessary delays in completing standards and would also minimise the likelihood of unnecessary differences between the standards that result.

5.1 IASB liaison members

Seven of the full-time members of the IASB have formal liaison responsibilities with national standard setters in order to promote the convergence of national accounting standards and International Financial Reporting Standards. The IASB envisages a partnership between the IASB and these national standard setters as they work together to achieve convergence of accounting standards world-wide.

In addition all IASB members have contact responsibility with national standards setters not having liaison members and many countries are also represented on the IFRS Advisory Council.

Exam focus point

This topic is likely to be examined as a short discussion question.

5.2 World-wide effect of IFRSs and the IASB

The IASB, and before it the IASC, has now been in existence for around 39 years, and it is worth looking at the effect it has had in that time.

As far as Europe is concerned, the consolidated financial statements of many of Europe's top multinationals are already prepared in conformity with national requirements, EC directives and IASs. These developments have been given added impetus by the internationalisation of capital markets. As discussed, IFRSs/IASs have been implemented in EU since 2005.

In Japan, the influence of the IASB had, until recently, been negligible. This was mainly because of links in Japan between tax rules and financial reporting. The Japanese Ministry of Finance set up a working committee to consider whether to bring national requirements into line with IFRSs/IASs. The Tokyo Stock Exchange has announced that it will accept financial statements from foreign issuers that conform with home country standards, which would include IFRS.

The Japanese standpoint was widely seen as an attempt to attract foreign issuers, in particular companies from Hong Kong and Singapore. As these countries base their accounting on international standards, this action is therefore implicit acknowledgement by the Japanese Ministry of Finance of IFRS/IAS requirements.

In **America**, the Securities and Exchange Commission (SEC) agreed in 1993 to allow foreign issuers (of shares, etc) to follow IFRS/IAS treatments on certain issues, including cash flow statements under IAS 7. The overall effect is that, where an IFRS/IAS treatment differs from US GAAP, these treatments will now be acceptable. The SEC is now supporting the IASB because it wants to attract foreign listings.

The following table summarises the status **for listed companies** as at June 2012:

Country	Status for listed companies
Argentina	Required for fiscal years beginning on or after 1 January 2012
Australia	Required for all private sector reporting entities and as the basis for public sector reporting since 2005
Brazil	Required for consolidated financial statements of banks and listed companies from 2013 and for individual company accounts progressively since January 2008
Canada	Required since 1 January 2011 for all listed entities and permitted for private sector entities including not-for-profit organisations
China	Substantially converged national standards
European Union	All member states of the EU are required to use IFRSs as adopted by the EU for listed companies since 2005
France	Required via EU adoption and implementation process since 2005
Germany	Required via EU adoption and implementation process since 2005
India	India is converging with IFRSs phased in from 2014.
Indonesia	Convergence process ongoing; a decision about a target date for full compliance with IFRSs is expected to be made in 2012
Italy	Required via EU adoption and implementation process since 2005
Japan	Permitted since 2010 for a number of international companies; decision about mandatory adoption by 2016 expected around 2012
Mexico	Required from 2012
Republic of Korea	Required since 2011
Russia	Required from 2012
Saudi Arabia	Required for banking and insurance companies. Full convergence with IFRSs currently under consideration.
South Africa	Required for listed entities since 2005
Turkey	Required for listed entities since 2005
United Kingdom	Required via EU adoption and implementation process since 2005
United States	Allowed for foreign issuers in the US since 2007; target date for substantial convergence with IFRSs was 2011 and decision about possible adoption for US companies has been put back for the foreseeable future.

Source: http://www.ifrs.org/Use-around-the-world/Pages/Use-around-the-world.aspx

However, there are several countries where the **use of IFRSs/IASs are not permitted**. The following are some of the countries, but the list is not exhaustive: Bangladesh, Iran, Malaysia, Pakistan, Senegal, Taiwan, Thailand, Tunisia and Vietnam.

5.3 Harmonisation in Europe

The objective of the European Commission (EC) is to build a fully integrated, globally competitive market. A key element of this is the harmonisation of company law across the member states. In line with this the **EC aims to establish a level playing field for financial reporting**, supported by an effective enforcement regime. The commission is uniquely the only organisation whose accounting standards are legally enforceable, in the form of directives which must be included in the national legislation of member states.

However, the directives have been criticised as they might become constraints on the application of world-wide standards, and might bring accounting standardisation and harmonisation into the political arena.

The EC adopted a regulation stating that from 2005 consolidated accounts of listed companies have been required to comply with IFRSs. The implications of this measure are far reaching. However, member states currently have the discretion to extend the implementation of IAS/IFRS to include non-listed companies. In the UK, for example, small companies report under UK GAAP, with many taking advantage of the reduced disclosure requirements of the FRSSE (Financial Reporting Standard for Smaller Entities). The IASB has recently issued the IFRS for SMEs (Small and Medium-sized Entities), which is an important step toward the introduction of IFRS for all companies.

Many commentators believe that in the light of the EC's commitment to IFRS it is only a matter of time before national standard setting bodies like the UK's FRC are, in effect, replaced by the IASB, with national standards falling into disuse. However, the IASB will continue to need input and expertise from valued national standard setters like the ASB.

5.4 IFRS in the USA

Convergence between IFRS and US GAAP is **one of the bigger issues** in the global implementation of IFRS. At present, all US entities must file accounts prepared under US GAAP. However, in 2002 the IASB and its US equivalent, the FASB (Financial Accounting Standards Board) did agree to harmonise their work plans, and to work towards reducing the differences between IFRS and US GAAP.

In **2008 the Securities and Exchange Commission (SEC) issued a 'roadmap'** for the use of IFRS, proposing the eventual mandatory use of IFRS for all US public companies by 2014. At present, only *overseas* issuers of securities are allowed to file accounts under IFRS (without having to provide a reconciliation to US GAAP).

5.5 Rules-based versus principles-based financial reporting standards

Exam focus point

> The expressions 'rules-based' and 'principles-based' may be used in a question. Ensure you understand what they mean.

US GAAP is an example of a rules-based approach. It consists of a large number of specific accounting standards, and each standard contains a large number of rules (as well as exceptions to the rules), attempting to prescribe treatments for every possible situation that might arise. However, in 2002 the incoming chairman of the **FASB** signalled his support for a **shift to a principles-based approach**:

> 'I understand the US environment where there has been such a proliferation of rules. I like the principles-based approach but some people have exaggerated the differences. You are always going to have rules but the question is: 'Where do I start?' You can never have a rule for everything and at that point you have to go back to principles.'
>
> Bob Hertz, FASB Chairman (*Financial Times*, 27 May 2002)

The US has accordingly begun to develop a principles-based approach, which coincides with its move toward adoption of IFRS, which are themselves principles-based.

A principles-based approach then, is one where the individual standards can be clearly seen to be applications of the approach to accounting adopted by the standards as a whole. Thus each individual IAS/IFRS applies the IASB *Framework*, and each standard is an individual reflection of the whole. Specificity at the level of detail is sacrificed for clarity in terms of the overall approach.

Accountants working under **IFRS** are required, then, to use **more professional judgement** than under a rules-based approach. There may not be a specific rule that applies to the event that they need to report, so they need to use judgement in applying the principles contained in the relevant IFRS. It is the view of the IASB that this will result in better quality financial reporting. Accounts will have to be **true to the overall principles of IFRS**, rather than to an individual rule that may not be appropriate for the event being reported, and which may therefore end up with an accounting treatment that is not true to the intentions of IFRS as a whole.

5.6 Brief comparison of IFRS v UK GAAP v US GAAP

To provide you with some practical perspective, here is a **very brief comparison** between IAS, UK GAAP and US GAAP requirements regarding three financial reporting areas.

Subject	UK GAAP	US GAAP	IFRS
Inventory valuation	The **LIFO** method is **not** permitted under UK GAAP, so the stock must be valued using a method such as FIFO (first in first out).	In the USA stock may be valued using the **LIFO** (last in first out) method. Under this method, assuming prices are rising, closing stock has a lower value than using FIFO.	IAS 2 (revised) requires use of FIFO or average methods for ordinarily interchangeable items.
Development expenditure	Development expenditure should be written off in year of expenditure, except in certain circumstances where it may be deferred.	Development expenditure must be recognised in profit and loss under all circumstances.	Under IAS 38 (revised) development costs are capitalised if certain criteria are met.

6 Feedback on the IASB

We will begin by looking at some of the feedback and issues relating to IFRSs, particularly where they offer a choice of treatment.

6.1 Financial reporting standards and choice

In favour of accounting standards (both national and international), the following points can be made.

- They reduce or eliminate confusing variations in the methods used to prepare accounts.
- They provide a focal point for debate and discussions about accounting practice.
- They oblige companies to disclose the accounting policies used in the preparation of accounts.
- They are a less rigid alternative to enforcing conformity by means of legislation.
- They have obliged companies to disclose more accounting information than they would otherwise have done if accounting standards did not exist, for example IAS 33 *Earnings per share*.

Many companies are reluctant to disclose information which is not required by national legislation. However, the following arguments may be put forward **against standardisation** and **in favour of choice**.

- A set of rules which give backing to one method of preparing accounts might be **inappropriate in some circumstances**. For example, IAS 16 on depreciation is inappropriate for investment properties (properties not occupied by the entity but held solely for investment), which are covered by IAS 40 on investment property.
- Standards may be subject to **lobbying or government pressure** (in the case of national standards). For example, in the USA, the accounting standard FAS 19 on the accounts of oil and gas companies led to a powerful lobby of oil companies, which persuaded the SEC (Securities and Exchange Commission) to step in. FAS 19 was then suspended.
- Many national standards are not based on a **conceptual framework of accounting**, although IFRSs are.
- There may be a **trend towards rigidity**, and away from flexibility in applying the rules.

6.2 Political problems

Exam focus point

Again, this area may provide useful material in addressing a question on harmonisation.

Any international body, whatever its purpose or activity, faces enormous political difficulties in attempting to gain **international consensus** and the IASB is no exception to this. How can the IASB reconcile the financial reporting situation between economies as diverse as third-world developing countries and sophisticated first-world industrial powers?

Developing countries are suspicious of the IASB, believing it to be dominated by the **USA.** This arises because acceptance by the USA listing authority, the Securities and Exchange Commission (SEC), of IASs is seen as a major hurdle to be overcome. For all practical purposes it is the American market which must be persuaded to accept IFRSs.

Developing countries are being catered for to some extent by the issue of a standard on **agriculture**, which is generally of much more relevance to such countries.

There are also tensions between the **UK/US model** of financial reporting and the **European model**. The UK/US model is based around investor reporting, whereas the European model is mainly concerned with tax rules, so shareholder reporting has a much lower priority.

The break-up of the former USSR and the move in many **Eastern European countries** to free-market economies has also created difficulties. It is likely that these countries will have to 'catch up' to international standards as their economies stabilise.

You must keep up to date with the IASB's progress and the problems it encounters in the financial press. You should also be able to discuss:

- **Due process** of the IASB
- **Use and application** of IFRSs
- **Future work** of the IASB
- **Criticisms** of the IASB

7 IFRS 1: First-time adoption of International Financial Reporting Standards 12/10

FAST FORWARD

You need to be aware of the technical requirements and practical managerial issues of implementing IFRS for the first time.

Exam focus point

Your examiner has stated that you are unlikely to be examined on the *detail* of IFRS 1. However, it is still an examinable document for Dip IFR, so you should read and work through this section so that you are ready for anything the examiner might ask you on it.

IFRS 1 sets out the precise way in which companies should implement a change from local accounting standards (their previous GAAP) to IASs and IFRSs. One of the main reasons for issuing a new standard was that listed companies in the EU were required to prepare their consolidated financial statements in accordance with IFRSs from 2005 onwards.

The standard is intended to ensure that an entity's first IFRS financial statements contain high quality information that: is transparent for users and comparable over all periods presented; provides a suitable starting point for accounting under IFRSs; and can be generated at a cost that does not exceed the benefits to users.

Key terms

Date of transition to IFRSs The beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS financial statements.

Deemed cost An amount used as a surrogate for cost or depreciated cost at a given date.

Fair value The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

First IFRS financial statements The first annual financial statements in which an entity adopts International Financial Reporting Standards (IFRSs), by an explicit and unreserved statement of compliance with IFRSs.

Opening IFRS statement of financial position An entity's statement of financial position (published or unpublished) at the date of transition to IFRSs.

Previous GAAP The basis of accounting that a first time adopter used immediately before adopting IFRSs.

Reporting period The latest period covered by financial statements or by an interim financial report .

(IFRS 1)

IFRS 1 **only applies** where an entity prepares IFRS financial statements **for the first time**. Changes in accounting policies made by an entity that already applies IFRSs should be dealt with by applying either IAS 8 or specific transitional requirements in other standards.

7.1 Making the transition to IFRS

An entity should:

(a) Select accounting policies that comply with IFRSs at the end of the reporting period for the entity's first IFRS financial statements.

(b) Prepare an opening IFRS statement of financial position at the date of transition to IFRSs. This is the starting point for subsequent accounting under IFRSs. The date of transition to IFRSs is the beginning of the earliest comparative period presented in an entity's first IFRS financial statements.

(c) Disclose the effect of the change in the financial statements.

7.2 Example: reporting period and opening IFRS statement of financial position

A listed company has a 31 December year-end and will be required to comply with IFRSs from 1 January 20X1.

Required

What is the date of transition to IFRSs?

7.3 Solution

The company's first IFRS financial statements will be for the year ended 31 December 20X1.

IFRS 1 requires that at least one year's comparative figures are presented in the first IFRS financial statements. The comparative figures will be for the year ended 31 December 20X0.

Therefore the date of transition to IFRSs is 1 January 20X0 and the company prepares an opening IFRS statement of financial position at this date.

7.4 Preparing the opening IFRS statement of financial position

IFRS 1 states that in its opening IFRS statement of financial position an entity shall:

(a) Recognise all assets and liabilities whose recognition is required by IFRSs

(b) Not recognise items as assets or liabilities if IFRSs do not permit such recognition

(c) Reclassify items that it recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset liability or component of equity under IFRSs

(d) Apply IFRS in measuring all recognised assets and liabilities

This involves restating the statement of financial position prepared at the same date under the entity's previous GAAP so that it complies with IASs and IFRSs in force at the end of the reporting period. In our example above, the company prepares its opening IFRS statement of financial position 1 January 20X0, following accounting policies that comply with IFRSs in force at 31 December 20X1.

The accounting policies that an entity uses in its opening IFRS statement of financial position may differ from those it used for the same date using its previous GAAP. The resulting adjustments are recognised directly in retained earnings (in equity) at the date of transition. (This is because the adjustments arise from events and transactions before the date of transition to IFRS.)

7.5 Exemptions from other IFRSs

A business may elect to use any or all of a range of exemptions. These enable an entity not to apply certain requirements of specific accounting standards retrospectively in drawing up its opening IFRS statement of financial position. Their purpose is to ensure that the cost of producing IFRS financial statements does not exceed the benefits to users.

7.5.1 Business combinations

IFRS 3 need not be applied retrospectively to business combinations that occurred before the date of the opening IFRS statement of financial position. This has the following consequences.

(a) Combinations keep the same classification (eg acquisition, uniting of interests) as in the previous GAAP financial statements.

(b) All acquired assets and liabilities are recognised other than:

   (i) Some financial assets and financial liabilities derecognised under the previous GAAP (derivatives and special purpose entities must be recognised);

   (ii) Assets (including goodwill) and liabilities that were not recognised under previous GAAP and would not qualify for recognition under IFRSs.

   Any resulting change is recognised by adjusting retained earnings (ie equity) unless the change results from the recognition of an intangible asset that was previously subsumed within goodwill.

(c) Items which do not qualify for recognition as an asset or liability under IFRSs must be excluded from the opening IFRS statement of financial position. For example, intangible assets that do not qualify for separate recognition under IAS 38 must be reclassified as part of goodwill.

(d) The carrying amount of goodwill in the opening IFRS statement of financial position is the same as its carrying amount under previous GAAP. However, goodwill must be tested for impairment at the transition date.

7.5.2 Property, plant and equipment

An entity may measure an item of property, plant and equipment at its fair value at the transition date and then use the fair value as its deemed cost at that date.

An entity may use a previous GAAP revaluation (or a valuation for the purpose of a privatisation or initial public offering) as the deemed cost at the transition date, so long as the revaluation was broadly comparable to fair value or depreciated replacement cost at the date of the valuation.

These exemptions are also available for:

(a) Investment properties measured under the cost model in IAS 40 *Investment property*

(b) Intangible assets that meet the recognition criteria and the criteria for revaluation in IAS 38 *Intangible assets*

7.5.3 Cumulative translation differences

IAS 21 requires some exchange differences to be classified as a separate component of equity, for example differences arising when the financial statements of a foreign operation are translated. The cumulative translation differences must be included in the gain or loss on disposal of the foreign operation. Under the exemption, the cumulative translation differences for all foreign operations are deemed to be zero at the transition date. The gain or loss on a subsequent disposal of a foreign operation will exclude translation differences that arose before the transition date. Later translation differences will be included.

7.5.4 Compound financial instruments

IAS 32 requires compound financial instruments to be split at inception into separate liability and equity components. If the liability component is no longer outstanding at the date of the translation to IFRSs, the split is not required.

7.5.5 Share-based payment transactions

An entity is encouraged, but not required to apply IFRS 2 to:

(a) Equity instruments that were granted and vested before the date of transition to IFRSs or 1 January 2005 (whichever is the later)

(b) Liabilities arising from share-based payment transactions that were settled before the date of transition to IFRSs

7.5.6 Financial instruments disclosures

In January 2010 IFRS 1 was amended to provide limited exemption from comparative IFRS 7 disclosures, so that first-time adopters of IFRSs have the same exemptions as existing IFRS preparers.

7.6 Exceptions to retrospective application of other IFRSs

IFRS 1 prohibits retrospective application of some other aspects of IFRSs.

(a) Hedge accounting: the conditions to qualify for hedge accounting apply prospectively from the date of transition to IFRSs.

(b) Estimates: Estimates under IFRSs at the date of transition must be consistent with those made at the same date under previous GAAP, (after adjustments to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.

Question

IFRS

Russell Co will adopt International Financial Reporting Standards (IFRSs) for the first time in its financial statements for the year ended 31 December 20X9.

In its previous financial statements for 31 December 20X7 and 20X8, which were prepared under local GAAP, the company made a number of routine accounting estimates, including accrued expenses. It also recognised a general provision for liabilities, calculated at a fixed percentage of its retained earnings for the year. This is required under its local GAAP.

Subsequently, some of the accruals were found to be overestimates and some were found to be underestimates.

Required

Discuss how the matters above should be dealt with in the IFRS financial statements of Russell Co for the year ended 31 December 20X9.

Answer

Provided that the routine accounting estimates have been made in a manner consistent with IFRSs no adjustments are made in the first IFRS financial statements. The only exception to this is if the company has subsequently discovered that these estimates were in error. Although there were some overestimates and some underestimates, this is probably not the case here.

The general provision is a different matter. This provision would definitely not have met the criteria for recognition under IAS 37 and therefore it will not be recognised in the opening IFRS statement of financial position (1 January 20X8) or at subsequent year-ends.

7.7 Presentation and disclosure

An entity's first IFRS financial statements must include at least one year of comparative information.

Comparative information need not comply with IAS 32 and IFRS 9; instead the entity may apply its previous GAAP and disclose this fact together with the nature of the main adjustments that would make the information comply with IAS 32 and IFRS 9.

An entity must also explain the effect of the transition from previous GAAP to IFRSs on its financial position, financial performance and cash flows by providing reconciliations:

(a) Of equity reported under previous GAAP to equity under IFRSs at the date of transition and at the reporting date

(b) Of the profit or loss reported under previous GAAP to profit or loss reported under IFRSs for the period

The reconciliations must give sufficient detail to enable users to understand the material adjustments to the statement of financial position and the statement of profit or loss and other comprehensive income.

If an entity presented a statement of cash flows under its previous GAAP, it should also explain the material adjustments to the statement of cash flows.

If an entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS statement of financial position, it must provide the disclosures that IAS 36 *Impairment of assets* would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRSs.

If an entity corrects errors made under previous GAAP, the reconciliations must distinguish the correction of errors from changes in accounting policies.

Where fair value has been used as deemed cost for a non-current asset in the opening IFRS statement of financial position as deemed cost for a non-current asset, the financial statements must disclose the aggregate of fair values and the aggregate adjustments to the carrying amounts reported under previous GAAP for each line in the opening IFRS statement of financial position.

7.8 Interim financial reports

IFRS 1 applies to any interim financial report that an entity presents under IAS 34 *Interim financial reporting* for part of the period covered by the first IFRS financial statements.

Where interim financial reports are presented, an entity should provide the same reconciliations required for full financial statements. Material adjustments to the statement of cash flows, if any, should also be disclosed.

7.9 Managing the change to International Standards

The implementation of the technical changes above is likely to entail careful management in most companies. Here are some of the change management considerations that should be addressed.

(a) **Accurate assessment of the task involved**. Underestimation or wishful thinking may hamper the effectiveness of the conversion and may ultimately prove inefficient.

(b) **Proper planning**. This should take place at the overall project level, but a detailed task analysis could be drawn up to control work performed.

(c) **Human resource management**. The project must be properly structured and staffed.

(d) **Training**. Where there are skills gaps, remedial training should be provided.

(e) **Monitoring and accountability**. A relaxed 'it will be alright on the night' attitude could spell danger. Implementation progress should be monitored and regular meetings set up so that participants can personally account for what they are doing as well as flag up any problems as early as possible. Project drift should be avoided.

(f) **Achieving milestones**. Successful completion of key steps and tasks should be appropriately acknowledged, ie what managers call 'celebrating success', so as to sustain motivation and performance.

(g) **Physical resourcing**. The need for IT equipment and office space should be properly assessed.

(h) **Process review**. Care should be taken not to perceive the change as a one-off quick fix. Any charge in future systems and processes should be assessed and properly implemented.

(i) **Follow-up procedures**. As with general good management practice, the follow up procedures should be planned in to make sure that the changes stick and that any further changes are identified and addressed.

7.10 Section summary

You need to be able to advise an entity making the change from previous GAAP to IFRSs on:

- The general rules (including the date of the opening IFRS statement of financial position)
- The exemptions available
- How to deal with estimates in previous financial statements
- Explaining the effects of the change on the financial statements (preparing reconciliations)
- The practical aspects of managing the change

Chapter Roundup

- A principles-based system works within a set of laid down principles. A rules-based system regulates for issues as they arise. Both of these have advantages and disadvantages.
- The need for harmonised financial reporting standards arises as a result of the globalisation of business activities and operations. Harmonised financial reporting standards are intended to provide:
  - A platform for wider investment choice
  - A more efficient capital market
  - Lower cost of capital
  - Enhanced business development
- The organisational structure consists of:
  - the IFRS Foundation
  - the IASB
  - the IFRS Advisory Council
  - the IFRS Interpretations Committee
- The EC, the UN, the IFAC, the OECD and the FASB all influence the harmonisation process.
- IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.
- You need to be aware of the technical requirements and practical managerial issues of implementing IFRS for the first time.

Quick Quiz

1 What recent decisions will have a beneficial effect on global harmonisation of accounting?

2 One objective of the IASB is to promote the preparation of financial statements using the euro.

True ☐

False ☐

3 A conceptual framework is:

A A theoretical expression of accounting standards
B A list of key terms used by the IASB
C A statement of theoretical principles which form the frame of reference for financial reporting
D The proforma financial statements

4 What development at the IASB aided users' interpretation of IFRSs?

5 Which of the following arguments is not in favour of accounting standards, but is in favour of accounting choice?

A They reduce variations in methods used to produce accounts
B They oblige companies to disclose their accounting policies
C They are a less rigid alternative to legislation
D They may tend towards rigidity in applying the rules

Answers to Quick Quiz

1 The IOSCO endorsement, and the EC requirement that listed companies should use IFRS from 2005.
2 False
3 C
4 The formation of the IFRS Interpretations Committee.
5 D The other arguments are all in favour of accounting standards.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q1	Introductory	n/a	n/a
Q2	Introductory	n/a	n/a
Q3	Introductory	n/a	n/a

2

The conceptual framework

Topic list	Syllabus reference
1 Conceptual framework and GAAP	A1
2 The IASB's *Conceptual Framework*	A1
3 The objective of general purpose financial reporting	A1
4 Underlying assumptions	A1
5 Qualitative characteristics of useful financial information	A1
6 The elements of financial statements	A1
7 Recognition of the elements of financial statements	A1
8 Measurement of the elements of financial statements	A1
9 Fair presentation and compliance with IFRS	A1

Introduction

The IASB's *Framework for the preparation and presentation of financial statements* has now been replaced by the *Conceptual Framework for Financial Reporting*

A conceptual framework for financial reporting can be defined as an attempt to codify existing **generally accepted accounting practice (GAAP)** in order to reappraise current accounting standards and to produce new standards.

Study guide

A1	**The International Accounting Standards Board (IASB) and the regulatory framework**
(a)	Understand and interpret the Financial Reporting Framework

1 Conceptual framework and GAAP

FAST FORWARD

There are advantages and disadvantages to having a conceptual framework.

1.1 The need for a conceptual framework

A **conceptual framework**, in the field we are concerned with, is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. These theoretical principles provide the basis for the development of new accounting standards and the evaluation of those already in existence.

The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. Therefore a conceptual framework will form the **theoretical basis** for determining which events should be accounted for, how they should be measured and how they should be communicated to the user.

Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The **danger of not having a conceptual framework** is demonstrated in the way some countries' standards have developed over recent years; standards tend to be produced in a **haphazard and fire-fighting approach**. Where an agreed framework exists, the standard-setting body act as an architect or designer, rather than a fire-fighter, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principles are tackled more than once in different standards, thereby producing **contradictions and inconsistencies** in basic concepts, such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

Another problem with the lack of a conceptual framework has become apparent in the USA. The large number of **highly detailed standards** produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. This would be avoided if a cohesive set of principles were in place.

A conceptual framework can also bolster standard setters **against political pressure** from various 'lobby groups' and interested parties. Such pressure would only prevail if it was acceptable under the conceptual framework.

1.2 Advantages and disadvantages of a conceptual framework

Advantages

(a) The situation is avoided whereby standards are developed on a **piecemeal** basis, where a particular accounting problem is recognised as having emerged, and resources were then channelled into **standardising accounting practice** in that area, without regard to whether that particular issue was necessarily the most important issue remaining at that time without standardisation.

(b) As stated above, the development of certain standards (particularly national standards) has been subject to considerable **political interference** from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be **less open to criticism** that the standard-setter buckled to external pressure.

Disadvantages

(a) Financial statements are intended for a **variety of users**, and it is not certain that a single conceptual framework can be devised which will suit all users.

(b) Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a **different purpose** (and with different concepts as a basis).

(c) It is not clear that a conceptual framework makes the task of **preparing and then implementing** standards any easier than without a framework.

Before we look at the IASB's attempt to produce a conceptual framework, we need to consider another term of importance to this debate: generally accepted accounting practice; or GAAP.

2 The IASB's *Conceptual Framework*

FAST FORWARD

The 1989 *Framework for the Preparation and Presentation of Financial Statements* was replaced in 2010 by the *Conceptual Framework for Financial Reporting*. This is the result of a joint project with the FASB.

The IASB *Framework for the Preparation and Presentation of Financial Statements* was produced in 1989 and is gradually being replaced by the new *Conceptual Framework for Financial Reporting*. This is being carried out in phases. The first phase, comprising Chapters 1 and 3, was published in September 2010. Chapter 2 entitled 'The reporting entity' has not yet been published. The current version of the *Conceptual Framework* includes the remaining chapters of the 1989 Framework as Chapter 4.

The *Conceptual Framework for Financial Reporting* is currently as follows:

Chapter 1: The objective of general purpose financial reporting

Chapter 2: The reporting entity (to be issued)

Chapter 3: Qualitative characteristics of useful financial information

Chapter 4: Remaining text of the 1989 Framework:

- Underlying assumption
- The elements of financial statements
- Recognition of the elements of financial statements
- Measurement of the elements of financial statements
- Concepts of capital and capital maintenance

We will look briefly at the introduction to the *Conceptual Framework* as this will place the document in context with the rest of what you have studied for this paper and in particular the context of the *Conceptual Framework* in the IASB's approach to developing IFRSs.

As you read through this chapter think about the impact it has had on standards, particularly the definitions.

2.1 Introduction

The Introduction to the *Conceptual Framework* points out the fundamental reason why financial statements are produced worldwide, ie to **satisfy the requirements of external users**, but that practice varies due to the individual pressures in each country. These pressures may be social, political, economic or legal, but they result in variations in practice from country to country, including the form of statements, the definition of their component parts (assets, liabilities etc), the criteria for recognition of items and both the scope and disclosure of financial statements.

It is these differences which the IASB wishes to narrow by **harmonising** all aspects of financial statements, including the regulations governing their accounting standards and their preparation and presentation.

The preface emphasises the way **financial statements are used to make economic decisions** and thus financial statements should be prepared to this end. The types of economic decisions for which financial statements are likely to be used include the following.

- Decisions to buy, hold or sell equity investments
- Assessment of management stewardship and accountability
- Assessment of the entity's ability to pay employees
- Assessment of the security of amounts lent to the entity
- Determination of taxation policies
- Determination of distributable profits and dividends
- Inclusion in national income statistics
- Regulations of the activities of entities

Any additional requirements imposed by **national governments** for their own purposes should not affect financial statements produced for the benefit of other users.

The *Conceptual Framework* recognises that financial statements can be prepared using a **variety of models**. Although the most common is based on historical cost and a nominal unit of currency (ie pound sterling, US dollar etc), the *Conceptual Framework* can be applied to financial statements prepared under a range of models.

2.2 Purpose and status

The introduction gives a list of the purposes of the *Conceptual Framework*.

(a) to assist the Board in the **development of future IFRSs** and in its review of existing IFRSs.

(b) to assist the Board in **promoting harmonisation** of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs.

(c) to assist **national standard-setting bodies** in developing national standards.

(d) to assist **preparers of financial statements** in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.

(e) to assist **auditors** in forming an opinion as to whether financial statements comply with IFRSs.

(f) to assist **users of financial statements** in interpreting the information contained in financial statements prepared in compliance with IFRSs.

(g) to provide those who are interested in the work of the IASB with **information** about its approach to the formulation of IFRSs.

The *Conceptual Framework* is not an IFRS and so does not overrule any individual IFRS. In the (rare) case of conflict between an IFRS and the *Conceptual Framework*, the **IFRS will prevail**.

2.2.1 Scope

The *Conceptual Framework* deals with:

(a) The **objective** of financial statements
(b) The **qualitative characteristics** that determine the usefulness of information in financial statements
(c) The **definition, recognition and measurement** of the elements from which financial statements are constructed
(d) Concepts of **capital and capital maintenance**

2.2.2 Users and their information needs

Users of accounting information consist of investors, employees, lenders, suppliers and other trade creditors, customers, government and their agencies and the public. You should be able to remember enough to do the following exercise.

Question — Users of financial information

Consider the information needs of the users of financial information listed above.

Answer

(a) **Investors** are the providers of risk capital

(i) Information is required to help make a decision about buying or selling shares, taking up a rights issue and voting.

(ii) Investors must have information about the level of dividend, past, present and future and any changes in share price.

(iii) Investors will also need to know whether the management has been running the company efficiently.

(iv) As well as the position indicated by the statement of profit or loss and other comprehensive income, statement of financial position and earnings per share (EPS), investors will want to know about the liquidity position of the company, the company's future prospects, and how the company's shares compare with those of its competitors.

(b) **Employees** need information about the security of employment and future prospects for jobs in the company, and to help with collective pay bargaining.

(c) **Lenders** need information to help them decide whether to lend to a company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate time and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.

(d) **Suppliers** need to know whether the company will be a good customer and pay its debts.

(e) **Customers** need to know whether the company will be able to continue producing and supplying goods.

(f) **Government's** interest in a company may be one of creditor or customer, as well as being specifically concerned with compliance with tax and company law, ability to pay tax and the general contribution of the company to the economy.

(g) The **public** at large would wish to have information for all the reasons mentioned above, but it could be suggested that it would be impossible to provide general purpose accounting information which was specifically designed for the needs of the public.

3 The objective of general purpose financial reporting

FAST FORWARD

The *Conceptual Framework* states that:

> 'The objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.'

These users need information about:

- The **economic resources of the entity**
- The **claims against the entity**
- Changes in the entity's **economic resources and claims**

Information about the entity's **economic resources and the claims against it** helps users to assess the entity's liquidity and solvency and its likely needs for additional financing.

Information about a reporting entity's financial performance (the **changes in its economic resources and claims**) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

The *Conceptual Framework* makes it clear that this information should be prepared on an **accruals basis**.

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

Financial statements prepared under the accruals basis show users past transactions involving cash and also obligations to pay cash in the future and resources which represent cash to be received in the future.

Information about a reporting entity's cash flows during a period also helps users assess the entity's **ability to generate future net cash inflows** and gives users a better understanding of its operations .

4 Underlying assumption

FAST FORWARD

Going concern is the underlying assumption in preparing financial statements.

Key term

Going concern. The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. *(Conceptual Framework)*

It is assumed that the entity has no intention to liquidate or curtail major operations. If it did, then the financial statements would be prepared on a **different (disclosed) basis.**

5 Qualitative characteristics of useful financial information

FAST FORWARD

The *Conceptual Framework* states that qualitative characteristics are the attributes that make financial information useful to users.

Chapter 3 of the *Conceptual Framework* distinguishes between **fundamental** and **enhancing** qualitative characteristics, for analysis purposes. Fundamental qualitative characteristics distinguish useful financial reporting information from information that is not useful or misleading. Enhancing qualitative characteristics distinguish more useful information from less useful information.

The two fundamental qualitative characteristics are **relevance** and **faithful representation**.

5.1 Relevance

Key term

Relevance. Relevant information is capable of making a difference in the decisions made by users. It is capable of making a difference in decisions in decisions if it has **predictive value**, **confirmatory value** or both. *(Conceptual Framework)*

The relevance of information is affected by its **nature** and its **materiality**.

Key term

Materiality. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. *(Conceptual Framework)*

5.2 Faithful representation

Key term

> **Faithful representation**. Financial reports represent **economic phenomena** in words and numbers. To be useful, financial information must not only represent relevant phenomena but must **faithfully represent** the phenomena that it purports to represent. *(Conceptual Framework)*

To be a faithful representation information must be **complete, neutral** and **free from error**.

A **complete** depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A **neutral** depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.

Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

5.2.1 Substance over form

This is **not a separate qualitative characteristic** under the *Conceptual Framework*. The IASB says that to do so would be redundant because it is **implied in faithful representation**. Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality**.

5.3 Enhancing qualitative characteristics

5.3.1 Comparability

Key term

> **Comparability**. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or date. *(Conceptual Framework)*

Consistency, although related to comparability, **is not the same**. It refers to the use of the same methods for the same items (i.e. consistency of treatment) either from period to period within a reporting entity or in a single period across entities.

The **disclosure of accounting policies** is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

When an entity **changes an accounting policy**, the change is applied retrospectively so that the results from one period to the next can still be usefully compared.

Comparability is **not the same as uniformity**. Entities should change accounting policies if those policies become inappropriate.

Corresponding information for preceding periods should be shown to enable comparison over time.

5.3.2 Verifiability

Key term

> **Verifiability**. Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. It means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation. *(Conceptual Framework)*

5.3.3 Timeliness

Key term

Timeliness. Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older information is the less useful it is. *(Conceptual Framework)*

Information may become less useful if there is a delay in reporting it. There is a **balance between timeliness and the provision of reliable information**.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error.

Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

5.3.4 Understandability

Key term

Understandability. Classifying, characterising and presenting information clearly and concisely makes it understandable. *(Conceptual Framework)*

Financial reports are prepared for users who have a **reasonable knowledge of business and economic activities** and who review and analyse the information diligently. Some phenomena are inherently complex and cannot be made easy to understand. Excluding information on those phenomena might make the information easier to understand, but without it those reports would be incomplete and therefore misleading. Therefore matters should not be left out of financial statements simply due to their difficulty as even well-informed and diligent users may sometimes need the aid of an advisor to understand information about complex economic phenomena.

The cost constraint on useful financial reporting

This is a pervasive constraint, not a qualitative characteristic. When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a **subjective area** and there are other difficulties: others, not the intended users, may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but preparers and users should be aware of the constraint.

6 The elements of financial statements

FAST FORWARD

Transactions and other events are grouped together in broad **classes** and in this way their financial effects are shown in the financial statements. These broad classes are the **elements** of financial statements.

The *Conceptual Framework* lays out these elements as follows.

Elements of financial statements

Measurement of financial position in Statement of financial position

- **Assets**
- **Liabilities**
- **Equity**

Measurement of performance in Statement of profit or loss and other comprehensive income

- **Income**
- **Expenses**

A process of **sub-classification** then takes place for presentation in the financial statements, eg assets are classified by their nature or function in the business to show information in the best way for users to take economic decisions.

6.1 Financial position

We need to define the three terms listed under this heading above.

Key terms

- **Asset**. A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- **Liability**. A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- **Equity**. The residual interest in the assets of the entity after deducting all its liabilities.

(Conceptual Framework)

These definitions are important, but they do not cover the **criteria for recognition** of any of these items, which are discussed in the next section of this chapter. This means that the definitions may include items which would not actually be recognised in the statement of financial position because they fail to satisfy recognition criteria particularly the **probable flow of any economic benefit** to or from the business.

Whether an item satisfies any of the definitions above will depend on the **substance and economic reality** of the transaction, not merely its legal form. For example, consider finance leases (see Chapter 16).

6.2 Assets

We can look in more detail at the components of the definitions given above.

Key term

Future economic benefit. The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

(Conceptual Framework)

Assets are usually employed to produce goods or services for customers; customers will then pay for these. **Cash itself** renders a service to the entity due to its command over other resources.

The existence of an asset, particularly in terms of **control**, is not reliant on:

(a) **Physical form** (hence patents and copyrights); *nor*
(b) **Legal rights** (hence leases).

Transactions or events **in the past** give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

6.3 Liabilities

Again we can look more closely at some aspects of the definition. An essential characteristic of a liability is that the entity has a **present obligation**.

Key term

Obligation. A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. *(Conceptual Framework)*

It is important to distinguish between a present obligation and a **future commitment**. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation.

Settlement of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash.

Liabilities must arise from **past transactions or events**. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.

6.3.1 Provisions

Is a provision a liability?

Key term

Provision. A present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated. *(Conceptual Framework)*

Question

Assets and liabilities

Consider the following situations. In each case, do we have an asset or liability within the definitions given by the *Conceptual Framework?* Give reasons for your answer.

(a) Pat Co has purchased a patent for $20,000. The patent gives the company sole use of a particular manufacturing process which will save $3,000 a year for the next five years.

(b) Baldwin Co paid Don Brennan $10,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.

(c) Deals on Wheels Co provides a warranty with every car sold.

Answer

(a) This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).

(b) This cannot be classified as an asset. Baldwin Co has no control over the car repair shop and it is difficult to argue that there are 'future economic benefits'.

(c) The warranty claims in total constitute a liability; the business has taken on an obligation. It would be recognised when the warranty is issued rather than when a claim is made.

6.4 Equity

Equity is defined above as a **residual**, but it may be sub-classified in the statement of financial position. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, eg for the future protection of creditors. The amount shown for equity depends on the **measurement of assets and liabilities.** It has nothing to do with the market value of the entity's shares.

6.5 Performance

Profit is used as a **measure of performance**, or as a basis for other measures (eg Earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

The elements of income and expense are therefore defined.

Key term

- **Income**. Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- **Expenses**. Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

(Conceptual Framework)

Income and expenses can be **presented in different ways** in the statement of profit or loss and other comprehensive income, to provide information relevant for economic decision-making. For example, income and expenses which relate to continuing operations are distinguished from the results of discontinued operations.

6.6 Income

Both **revenue** and **gains** are included in the definition of income. **Revenue** arises in the course of ordinary activities of an entity.

Key term

Gains. Increases in economic benefits. As such they are no different in nature from revenue. *(Conceptual Framework)*

Gains include those arising on the disposal of non-current assets. The definition of income also includes **unrealised gains**, eg on revaluation of marketable securities.

6.7 Expenses

As with income, the definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity.

Key term

Losses. Decreases in economic benefits. As such they are no different in nature from other expenses. *(Conceptual Framework)*

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealised losses**, eg the fall in value of an investment.

6.8 Section summary

Make sure you learn the important definitions.

- Financial position:
  - Assets
  - Liabilities
  - Equity
- Financial performance:
  - Income
  - Expenses

7 Recognition of the elements of financial statements

FAST FORWARD

Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.

Key term

> **Recognition**. The process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:
>
> (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
>
> (b) the item has a cost or value that can be measured with reliability.
>
> *(Conceptual Framework)*

Regard must be given to **materiality** (see Section 5 above).

7.1 Probability of future economic benefits

Probability here means the **degree of uncertainty** that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the **characteristics of the entity's environment** and the **evidence available** when the financial statements are prepared.

7.2 Reliability of measurement

The cost or value of an item, in many cases, **must be estimated**. The *Conceptual Framework* states, however, that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition **at a later date** due to changes in circumstances or subsequent events.

7.3 Assets which cannot be recognised

The recognition criteria do not cover items which many businesses may regard as assets. A skilled workforce is an undoubted asset but workers can leave at any time so there can be no certainty about the probability of future economic benefits. A company may have come up with a new name for its product which is greatly increasing sales but, as it did not buy the name, the name does not have a cost or value that can be reliably measured, so it is not recognised.

7.4 Recognition of items

We can summarise the recognition criteria for assets, liabilities, income and expenses, based on the definition of recognition given above.

Item	Recognised in	When
Asset	The statement of financial position	It is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
Liability	The statement of financial position	It is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
Income	The statement of profit or loss and other comprehensive income	An increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.
Expenses	The statement of profit or loss and other comprehensive income	A decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

8 Measurement of the elements of financial statements

FAST FORWARD

A number of different measurement bases are used in financial statements. They include

- Historical cost
- Current cost
- Realisable (settlement) value
- Present value of future cash flows

Measurement is defined as follows.

Key term

Measurement. The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income. *(Conceptual Framework)*

This involves the selection of a particular **basis of measurement**. A number of these are used to different degrees and in varying combinations in financial statements. They include the following.

Key terms

Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realisable (settlement) value.

- **Realisable value**. The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
- **Settlement value**. The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present value. A current estimate of the present discounted value of the future net cash flows in the normal course of business. *(Conceptual Framework)*

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, eg inventory is carried at the lower of cost and net realisable value.

Recent standards use the concept of **fair value**, which is defined by **IFRS 13** as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

Example

A machine was purchased on 1 January 20X8 for $3m. That was its original cost. It has a useful like of 10 years and under the **historical cost convention** it will be carried at **original cost less accumulated depreciation**. So in the financial statements at 31 December 20X9 it will be carried at:

$3m – (0.3 × 2) = $2.4m

The current cost of the machine, which will probably also be its fair value, will be fairly easy to ascertain if it is not too specialised. For instance, two year old machines like this one may currently be changing hands for $2.5m, so that will be an appropriate fair value.

The **net realisable value** of the machine will be the amount that could be obtained from selling it, less any costs involved in making the sale. If the machine had to be dismantled and transported to the buyer's premises at a cost of $200,000, the NRV would be $2.3m.

The **replacement cost** of the machine will be the cost of a new model less two year's depreciation. The cost of a new machine may now be $3.5m. Assuming a 10-year life, the replacement cost will therefore be $2.8m.

The **present value** of the machine will be the discounted value of the future cash flows that it is expected to generate. If the machine is expected to generate $500,000 per annum for the remaining 8 years of its life and if the company's cost of capital is 10%, present value will be calculated as:

$500,000 × 5.335* = $2667,500

* Cumulative present of $1 per annum for eight years discounted at 10%

9 Fair presentation and compliance with IFRS

Most importantly, financial statements should **present fairly** the financial position, financial performance and cash flows of an entity. **Compliance with IFRS** is presumed to result in financial statements that achieve a fair presentation.

IAS 1 stipulates that financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Conceptual Framework*.

The following points made by IAS 1 expand on this principle.

(a) **Compliance with IFRS** should be disclosed

(b) **All relevant IFRS** must be followed if compliance with IFRS is disclosed

(c) Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material

IAS 1 states what is required for a fair presentation.

(a) Selection and application of **accounting policies**

(b) **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information

(c) **Additional disclosures** where required

Chapter Roundup

- There are advantages and disadvantages to having a conceptual framework.
- The 1989 *Framework for the Preparation and Presentation of Financial Statements* was replaced in 2010 by the *Conceptual Framework for Financial Reporting*. This is the result of a joint project with the FASB.
- The *Conceptual Framework* states that:

  'The objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.'

- **Going concern** is the underlying assumption in preparing financial statements.
- The *Conceptual Framework* states that qualitative characteristics are the attributes that make financial information useful to users.
- Transactions and other events are grouped together in broad **classes** and in this way their financial effects are shown in the financial statements. These broad classes are the **elements** of financial statements.
- Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.
- A number of different measurement bases are used in financial statements. They include:
  - Historical cost
  - Current cost
  - Realisable (settlement) value
  - Present value of future cash flows

Quick Quiz

1. Define a 'conceptual framework'.
2. What are the advantages and disadvantages of developing a conceptual framework?
3. The needs of which category of user are paramount when preparing financial statements?
4. Define 'relevance'.
5. In which two ways should users be able to compare an entity's financial statements?
6. A provision can be a liability. True or false?
7. Define 'recognition'.
8. The cost or value of items in the financial statements is never estimated. True or false?
9. What is the most common basis of measurement used in financial statements?

Answers to Quick Quiz

1 This is a statement of generally accepted theoretical principles, which form the frame of reference for financial reporting.

2 *Advantages*

- Standardised accounting practice
- Less open to criticism
- Concentrate on statement of profit or loss and other comprehensive income or statement of financial position, as appropriate

Disadvantages

- Variety of users, so not all will be satisfied
- Variety of standards for different purposes
- Preparing and implementing standards not necessarily any easier

3 Needs of investors

4 Information has relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming (or correcting) their past evaluations.

5
- Through time to identify trends
- With other entities' statements

6 True. It satisfies the definition of a liability but the amount may need to be estimated.

7 See Key Term Section 7.

8 False. Monetary values are often estimated.

9 Historical cost.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q4	Introductory	n/a	n/a
Q5	Introductory	n/a	n/a

P

A

R

T

B

Elements of financial statements

Revenue recognition

3

Topic list	Syllabus reference
1 Revenue recognition	B1

Introduction

We will look at the timing of revenue recognition and we will look at the question of **substance over form** and the kind of transactions undertaken by entities trying to avoid reporting true substance.

The main weapon in tackling these abuses is the IASB's *Conceptual Framework for Financial Reporting* because it applies **general definitions** to the elements that make up financial statements.

Study guide

B1	**Revenue recognition**
(a)	Outline the principles of the timing of revenue recognition
(b)	Explain the concept of substance over form in relation to recognising sales revenue
(c)	Discuss the various points in the production and sales cycle where it may, depending on circumstances, be appropriate to recognise gains and losses – give examples of this
(d)	Describe the IASB's approach to revenue recognition

1 Revenue recognition

FAST FORWARD

Revenue recognition is straightforward in most business transactions, but some situations are more complicated and some give opportunities for manipulation.

Exam focus point

The principles of IAS 18 *Revenue* are examined frequently, and a question on this area is likely to come up in almost every sitting.

1.1 Introduction

Accruals accounting is based on the **matching of costs with the revenue they generate**. It is crucially important under this convention that we can establish the point at which revenue may be recognised so that the correct treatment can be applied to the related costs. For example, the costs of producing an item of finished goods should be carried as an asset in the statement of financial position until such time as it is sold; they should then be written off as a charge to the trading account. Which of these two treatments should be applied cannot be decided until it is clear at what moment the sale of the item takes place.

The decision has a **direct impact on profit** since under the prudence concept it would be unacceptable to recognise the profit on sale until a sale had taken place in accordance with the criteria of revenue recognition.

1.2 Point of sale

FAST FORWARD

BASIC REQUIREMENT

Revenue is generally recognised as **earned at the point of sale**, because at that point four criteria will generally have been met.

- The product or service has been **provided to the buyer**.
- The buyer has **recognised his liability** to pay for the goods or services provided. The converse of this is that the seller has recognised that ownership of goods has passed from himself to the buyer.
- The buyer has indicated his **willingness to hand over cash** or other assets in settlement of his liability.
- The **monetary value** of the goods or services has been established.

At earlier points in the business cycle there will not in general be **firm evidence** that the above criteria will be met. Until work on a product is complete, there is a risk that some flaw in the manufacturing process will necessitate its writing off; even when the product is complete there is no guarantee that it will find a buyer.

At later points in the business cycle, for example when cash is received for the sale, the recognition of revenue may occur in a period later than that in which the related costs were charged. Revenue

recognition would then depend on fortuitous circumstances, such as the cash flow of a company's customers, and might fluctuate misleadingly from one period to another.

However, there are times when revenue is **recognised at other times than at the completion of a sale**. For example, in the recognition of profit on long-term construction contracts. Under IAS 11 *Construction contracts* (see Chapter 8) contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period.

(a) Owing to the length of time taken to complete such contracts, to defer taking profit into account until completion may result in the statement of profit and loss reflecting not so much a fair view of the activity of the company during the year, but rather the results relating to contracts which have been completed by the year end.

(b) Revenue in this case is recognised when production on, say, a section of the total contract is complete, even though no sale can be made until the whole is complete.

1.3 IAS 18 Revenue

IAS 18 governs the recognition of revenue in specific (common) types of transaction. Generally, recognition should be when it is probable that **future economic benefits** will flow to the entity and when these benefits can be **measured reliably**.

Income, as defined by the IASB *Conceptual Framework* includes both revenues and gains. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends or royalties.

1.4 Scope

FAST FORWARD

IAS 18 *Revenue* is concerned with the **recognition of revenues** arising from fairly common transactions or events.

- The sale of goods
- The rendering of services
- The use by others of entity assets yielding interest, royalties and dividends

Interest, royalties and dividends are included as income because they arise from the use of an entity's assets by other parties.

Key terms

Interest is the charge for the use of cash or cash equivalents or amounts due to the entity.

Royalties are charges for the use of non-current assets of the entity, eg patents, computer software and trademarks.

Dividends are distributions of profit to holders of equity investments, in proportion with their holdings, of each relevant class of capital.

The Standard specifically **excludes** various types of revenue arising from leases, insurance contracts, changes in value of financial instruments or other current assets, natural increases in agricultural assets and mineral ore extraction.

1.5 Definitions

The following definitions are relevant.

Key terms

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants. (IAS 18)

Key terms (cont'd)

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13)

Revenue **does not include** sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an economic benefit flowing to the entity. The same is true for revenues collected by an agent on behalf of a principal. Revenue for the agent is only the commission received for acting as agent.

1.6 Measurement of revenue

FAST FORWARD

Generally revenue is recognised when the entity has transferred to the buyer the **significant risks and rewards of ownership** and when the revenue can be **measured reliably**.

When a transaction takes place, the amount of revenue is usually decided by the **agreement of the buyer and seller**. The revenue is actually measured, however, as the **fair value of the consideration received**, which will take account of any trade discounts and volume rebates.

1.7 Identification of the transaction

Normally, each transaction can be looked at **as a whole**. Sometimes, however, transactions are more complicated, and it is necessary to break a transaction down into its **component parts**. For example, a sale may include the transfer of goods and the provision of future servicing, the revenue for which should be deferred over the period the service is performed.

At the other end of the scale, **seemingly separate transactions must be considered together** if apart they lose their commercial meaning. An example would be to sell an asset with an agreement to buy it back at a later date. The second transaction cancels the first and so both must be considered together. We looked at sale and repurchase in Section 4.2.

Exam focus point

The June 2010 paper included a whole question on the requirements of IAS 18. The candidate had to outline the requirements of the standard, compare the definition of revenue with that in *Framework*, and apply IAS 18 to the specific transactions.

By contrast, the December 2013 paper featured a question part with a simple requirement to explain the criteria for recognising revenue from the sale of goods and services, and the basis on which revenue is measured, all for six marks.

1.8 Sale of goods

Revenue from the sale of goods should only be recognised when *all* these conditions are satisfied.

(a) The entity has transferred the **significant risks and rewards** of ownership of the goods to the buyer

(b) The entity has **no continuing managerial involvement** to the degree usually associated with ownership, and no longer has effective control over the goods sold

(c) The amount of revenue can be **measured reliably**

(d) It is probable that the **economic benefits** associated with the transaction will flow to the entity

(e) The **costs incurred** in respect of the transaction can be measured reliably

The transfer of risks and rewards can only be decided by examining each transaction. Mainly, the transfer occurs at the same time as either the **transfer of legal title**, or the **passing of possession** to the buyer – this is what happens when you buy something in a shop.

If **significant risks and rewards remain with the seller**, then the transaction is *not* a sale and revenue cannot be recognised, for example if the receipt of the revenue from a particular sale depends on the buyer receiving revenue from his own sale of the goods.

It is possible for the seller to retain only an **'insignificant' risk of ownership** and for the sale and revenue to be recognised. The main example here is where the seller retains title only to ensure collection of what is owed on the goods. This is a common commercial situation, and when it arises the revenue should be recognised on the date of sale.

The probability of the entity receiving the revenue arising from a transaction must be assessed. It may only become probable that the economic benefits will be received when an uncertainty is removed, for example government permission for funds to be received from another country. Only when the uncertainty is removed should the revenue be recognised. This is in contrast with the situation where revenue has already been recognised but where the **collectability of the cash** is brought into doubt. Where recovery has ceased to be probable, the amount should be recognised as an expense, *not* an adjustment of the revenue previously recognised. These points also refer to services and interest, royalties and dividends below.

Matching should take place, ie the revenue and expenses relating to the same transaction should be recognised at the same time. It is usually easy to estimate expenses at the date of sale (eg warranty costs, shipment costs, etc). Where they cannot be estimated reliably, then revenue cannot be recognised; any consideration which has already been received is treated as a liability.

1.9 Example

A washing machine sells for $500 with a one-year warranty. The dealer knows from experience that 15% of these machines develop a fault in the first year and that the average cost of repair is $100. He sells 200 machines. How does he account for this sale?

Solution

He will recognise revenue of $100,000 ($500 × 200) and an associated provision of $3,000 ($100 × 200 × 15%).

1.10 Servicing fees included in the price

The sales price of a product may include an identifiable amount for subsequent servicing. In this case, that amount is deferred and recognised as revenue over the period during which the service is performed. The amount deferred must cover the cost of those services together with a reasonable profit on those services.

1.11 Example

A computerised accountancy package is sold with one year's after sales support. The cost of providing support to one customer for one year is calculated to be $50. The company has a mark-up on cost of 15%. The product is sold for $350. How is this sale accounted for?

Solution

$57.50 (50 + (50 × 15%)) will be treated as deferred income and recognised over the course of the year.

The remaining $292.50 will be treated as revenue.

1.12 Rendering of services

When the outcome of a transaction involving the rendering of services can be estimated reliably, the associated revenue should be recognised by reference to the **stage of completion of the transaction** at the end of the reporting period. The outcome of a transaction can be estimated reliably when *all* these conditions are satisfied.

(a) The amount of revenue can be **measured reliably**

(b) It is probable that the **economic benefits** associated with the transaction will flow to the entity

(c) The **stage of completion** of the transaction at the end of the reporting period can be measured reliably

(d) The **costs incurred** for the transaction and the costs to complete the transaction can be measured reliably

The parties to the transaction will normally have to agree the following before an entity can make reliable estimates.

(a) Each party's **enforceable rights** regarding the service to be provided and received by the parties
(b) The **consideration** to be exchanged
(c) The **manner and terms of settlement**

There are various methods of determining the stage of completion of a transaction, but for practical purposes, when services are performed by an indeterminate number of acts over a period of time, revenue should be recognised on a **straight line basis** over the period, unless there is evidence for the use of a more appropriate method. If one act is of more significance than the others, then the significant act should be carried out *before* revenue is recognised.

In uncertain situations, when the outcome of the transaction involving the rendering of services cannot be estimated reliably, the standard recommends a **no loss/no gain approach**. Revenue is recognised only to the extent of the expenses recognised that are recoverable.

This is particularly likely during the **early stages of a transaction**, but it is still probable that the entity will recover the costs incurred. So the revenue recognised in such a period will be equal to the expenses incurred, with no profit.

Obviously, if the costs are not likely to be reimbursed, then they must be recognised as an expense immediately. **When the uncertainties cease to exist**, revenue should be recognised as laid out in the first paragraph of this section.

1.13 Substance over form

Key term

Substance over form. The principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

In some cases, what initially appears to be a sale transaction may turn out to be something different and a sale should not be recognised. It is important that the substance of the transaction is reported and not just its legal form. In other words, you need to understand exactly what is happening with a single transaction or series of transactions. This term is no longer included within the *Conceptual Framework*, but it is implied by the concept of **faithful representation**.

For example, MacDougal Drinks sold 100 barrels of Brew No 1 to the Scots Bank, on 30 June 20X9 for $100 per barrel. When Brew No 1 is mature in two years time it will be worth $500 per barrel. MacDougal retains custody of the barrels. The sale contract contains a clause requiring MacDougal to repurchase the barrels on 30 June 20Y1 for $150 per barrel.

How should this transaction be recognised?

Solution

Often, the substance of a transaction can only be determined by looking at all transactions relating to an item as a whole.

In this case, MacDougal sells his barrels to the Scots Bank which would appear to be a standard transaction. However, on maturity of the barrels, he repurchases them from the bank. It is important to note that he does not physically give the barrels to the bank, they are still kept at his premises.

Normally once an item is sold, the goods are transferred and the seller transfers the risks and rewards of ownership to the purchaser. This does not happen in this case. MacDougal still retains physical ownership and with the option of buying the barrels back at below their market price, retains the rewards of ownership.

In substance, this transactions is not a sale. Rather, it is a loan from Scots Bank to MacDougal, secured on the inventory.

The accounting for this transaction is to continue to recognise the barrels as inventory and record the cash received from the bank as the proceeds of a loan. The difference between the $100 'sales' price and the $150 repurchase price should be accounted for as loan interest over the two year period of the loan. No sale has taken place.

1.14 Interest, royalties and dividends

When others use the entity's assets yielding interest, royalties and dividends, the revenue should be recognised on the bases set out below when:

(a) it is probable that the **economic benefits** associated with the transaction will flow to the entity; and
(b) the amount of the revenue can be **measured reliably**.

The revenue is recognised on the following bases.

(a) **Interest** is recognised on a time proportion basis that takes into account the effective yield on the asset
(b) **Royalties** are recognised on an accruals basis in accordance with the substance of the relevant agreement
(c) **Dividends** are recognised when the shareholder's right to receive payment is established

It is unlikely that you would be asked about anything as complex as this in the exam, but you should be aware of the basic requirements of the Standard. The **effective yield** on an asset mentioned above is the rate of interest required to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of the asset.

Royalties are usually recognised on the same basis that they accrue **under the relevant agreement**. Sometimes the true substance of the agreement may require some other systematic and rational method of recognition.

Once again, the points made above about **probability and collectability** on sale of goods also apply here.

1.15 Disclosure

The following items should be disclosed.

(a) The **accounting policies** adopted for the recognition of revenue, including the methods used to determine the stage of completion of transactions involving the rendering of services

(b) The amount of each **significant category of revenue** recognised during the period including revenue arising from:

   (i) The sale of goods
   (ii) The rendering of services
   (iii) Interest
   (iv) Royalties
   (v) Dividends

(c) The amount of revenue arising from **exchanges of goods or services** included in each significant category of revenue

Any **contingent gains or losses**, such as those relating to warranty costs, claims or penalties should be treated according to IAS 37 *Provisions, contingent liabilities and contingent assets* (covered in Chapter 9).

Question — Recognition

Discuss under what circumstances, if any, revenue might be recognised at the following stages of a sale.

(a) Goods are acquired by the business which it confidently expects to resell very quickly.
(b) A customer places a firm order for goods.
(c) Goods are delivered to the customer.

(d) The customer is invoiced for goods.
(e) The customer pays for the goods.
(f) The customer's cheque in payment for the goods has been cleared by the bank.

Answer

(a) A sale must never be recognised before the goods have even been ordered by a customer. There is no certainty about the value of the sale, nor when it will take place, even if it is virtually certain that goods will be sold.

(b) A sale must never be recognised when the customer places an order. Even though the order will be for a specific quantity of goods at a specific price, it is not yet certain that the sale transaction will go through. The customer may cancel the order, the supplier might be unable to deliver the goods as ordered or it may be decided that the customer is not a good credit risk.

(c) A sale will be recognised when delivery of the goods is made only when:

   (i) the sale is for cash, and so the cash is received at the same time; or
   (ii) the sale is on credit and the customer accepts delivery (eg by signing a delivery note).

(d) The critical event for a credit sale is usually the despatch of an invoice to the customer. There is then a legally enforceable debt, payable on specified terms, for a completed sale transaction.

(e) The critical event for a cash sale is when delivery takes place and when cash is received; both take place at the same time.

   It would be too cautious or 'prudent' to await cash payment for a credit sale transaction before recognising the sale, unless the customer is a high credit risk and there is a serious doubt about his ability or intention to pay.

(f) It would again be over-cautious to wait for clearance of the customer's cheques before recognising sales revenue. Such a precaution would only be justified in cases where there is a very high risk of the bank refusing to honour the cheque.

Question

Revenue recognition

Caravans Deluxe is a retailer of caravans, dormer vans and mobile homes, with a year end of 30 June 20X8. It is having trouble selling one model – the $30,000 Mini-Lux, and so is offering incentives for customers who buy this model before 31 May 20X7:

(a) Customers buying this model before 31 May 20X7 will receive a period of interest free credit, provided they pay a non-refundable deposit of $3,000, an instalment of $15,000 on 1 August 20X7 and the balance of $12,000 on 1 August 20X9.
(b) A three-year service plan, normally worth $1,500, is included free in the price of the caravan.

On 1 May 20X7, a customer agrees to buy a Mini-Lux caravan, paying the deposit of $3,000. Delivery is arranged for 1 August 20X7.

As the sale has now been made, the director of Caravans Deluxe wishes to recognise the full sale price of the caravan, $30,000, in the accounts for the year ended 30 June 20X7.

Required

Advise the director of the correct accounting treatment for this transaction. Assume a 10% discount rate. Show the journal entries for this treatment.

Answer

The director wishes to recognise the sale as early as possible. However, following IAS 18 *Revenue*, he cannot recognise revenue from this sale because the risks and rewards of ownership of the caravan have not been transferred. This happens on the date of delivery, which is 1 August 20X7. Accordingly, no revenue can be recognised in the current period.

The receipt of cash in the form of the $3,000 deposit must be recognised. However, while the deposit is termed 'non-refundable', it does create an obligation to complete the contract. The other side of the entry is therefore to deferred income in the statement of financial position.

The journal entries would be as follows:

DEBIT	Cash	$3,000	
CREDIT	Deferred income		$3,000

Being deposit received in advance of the sale being recognised.

On 1 August 20X7, when the sale is recognised, this deferred income account will be cleared. In addition:

The revenue from the sale of the caravan will be recognised. Of this, $12,000 is receivable in two years' time, which, with a 10% discount rate, is: $12,000/ 1.1^2 = $9,917. $15,000 is receivable on 1 August 20X7.

The service plan is not really 'free' – nothing is. It is merely a deduction from the cost of the caravan. The $1,500 must be recognised separately. It is deferred income and will be recognised over the three year period.

The sales revenue recognised in respect of the caravan will be a balancing figure.

The journal entries are as follows:

DEBIT	Deferred income	$3,000	
DEBIT	Cash (1st instalment)	$15,000	
DEBIT	Receivable (balance discounted)	$9,917	
CREDIT	Deferred income (service plan monies received in advance)		$1,500
CREDIT	Sales (balancing figure)		$26,417

BPP Note. This question is rather fiddly, so do not worry too much if you didn't get all of it right. Read through our solution carefully, going back to first principles where required.

1.16 Principal or agent?

Previously, IAS 18 covered the **accounting treatment** for amounts collected by an agent on behalf of a principal, which is: recognise only the commission as revenue (not the amounts collected on behalf of the principal). However, it did not give guidance on determining whether an entity is acting as agent or principal.

In April 2009, the IASB issued some improvements to IFRS, most of which are minor. The most significant change is the additional guidance in the appendix to IAS 18 *Revenue* on determining whether an entity is acting as an agent or principal. The guidance is as follows.

1.16.1 Acting as principal

An entity is acting as a principal when it is **exposed to the significant risks and rewards** associated with the sale of goods or rendering of services. Features that indicate that an entity is acting as a principal include (individually or in combination):

(a) **Primary responsibility** for providing goods or services to the customer or for fulfilling the order

(b) The entity having the **inventory risk** before or after the customer order, during shipping or on return

(c) **Discretion in establishing prices** (directly or indirectly) eg providing additional goods or services

(d) The entity bearing the **customer's credit risk** for the amount receivable from the customer

1.16.2 Acting as agent

An entity is acting as an agent when it is **not exposed to the significant risks and rewards** associated with the sale of goods or rendering of services. One feature that indicates that an entity is an agent is that the amount the entity earns is **predetermined** eg fixed fee per transaction or percentage of amount billed to the customer.

Chapter Roundup

- Revenue recognition is straightforward in most business transactions, but some situations are more complicated and give some opportunities for manipulation.
- Revenue is generally recognised as **earned at the point of sale**, because at that point four criteria will generally have been met.
  - The product or service has been **provided to the buyer**.
  - The buyer has **recognised his liability** to pay for the goods or services provided. The converse of this is that the seller has recognised that ownership of goods has passed from himself to the buyer.
  - The buyer has indicated his **willingness to hand over cash** or other assets in settlement of his liability.
  - The **monetary value** of the goods or services has been established.
- IAS 18 *Revenue* is concerned with the **recognition of revenues** arising from fairly common transactions or events.
  - The sale of goods
  - The rendering of services
  - The use by others of entity assets yielding interest, royalties and dividends
- Generally revenue is recognised when the entity has transferred to the buyer the **significant risks and rewards of ownership** and when the revenue can be **measured reliably**.

Quick Quiz

1 Revenue recognition is governed by which IAS?

2 Revenue should be measured at the ………………….. value of the ……………………… received or receivable.

3 Explain in no more than 40 words, when revenue from sale of goods should be recognised.

Answers to Quick Quiz

1 IAS 18

2 Fair, consideration

3 Revenue from the **sale of goods** should be recognised when the **significant risks** and **rewards** of ownership have been **transferred** to the buyer, the seller has lost effective control and the amount of revenue can be measured reliably.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q6	Examination	20	36 mins

4

Property, plant and equipment

Topic list	Syllabus reference
1 IAS 16 Property, plant and equipment	B2
2 Depreciation accounting	B2
3 IAS 20 Government grants	B2
4 IAS 40 Investment property	B2
5 IAS 23 Borrowing costs	B2

Introduction

IAS 16 should be familiar to you from your earlier studies, as should the mechanics of accounting for depreciation, revaluations of non-current assets and disposals of non-current assets. Some questions are given here for revision purposes.

IAS 20 on government grants is a straightforward standard and you should have few problems with it.

IAS 40 deals with investment properties, which can be treated differently from other property under IAS 16.

Study guide

B2	**Property, plant and equipment**
(a)	Define the initial cost of a non-current asset (including a self-constructed asset) and apply this to various examples of expenditure, distinguishing between capital and revenue items
(b)	Identify pre-conditions for the capitalisation of borrowing costs
(c)	Describe, and be able to identify, subsequent expenditures that should be capitalised
(d)	State and appraise the effects of the IASB's rules for the revaluation of property, plant and equipment
(e)	Account for gains and losses on the disposal of re-valued assets
(f)	Calculate depreciation on: – revalued assets, and – assets that have two or more major items or significant parts
(g)	Apply the provisions of accounting standards relating to government grants and government assistance
(j)	Discuss the way in which the treatment of investment properties differs from other properties
(k)	Apply the requirements of international accounting standards to investment properties.

1 IAS 16 Property, plant and equipment

FAST FORWARD

IAS 16 covers all aspects of accounting for property, plant and equipment. This represents the bulk of items which are **'tangible' non-current assets**.

Exam focus point

IAS 16 is a fundamental standard for Dip IFR and is examined frequently. You need to become very familiar with its requirements. Be careful, as it can be surprisingly tricky in exam questions.

1.1 Scope

IAS 16 should be followed when accounting for property, plant and equipment *unless* another international accounting standard requires a **different treatment**.

IAS 16 **does not apply** to the following.

(a) Biological assets related to agricultural activity
(b) Mineral rights and mineral reserves, such as oil, gas and other non-regenerative resources

However, the standard applies to property, plant and equipment used to develop these assets.

1.2 Definitions

The standard gives a large number of definitions.

Key terms

- **Property, plant and equipment** are tangible assets that:
  - are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
  - are expected to be used during more than one period.
- **Cost** is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.
- **Residual value** is the net amount which the entity expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.
- **Entity specific value** is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life, or expects to incur when settling a liability.
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13)
- **Carrying amount** is the amount at which an asset is recognised in the statement of financial position after deducting any accumulated depreciation and accumulated impairment losses.
- An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount. *(IAS 16)*

Note that the definition of fair value has now been changed by IFRS 13. See Chapters 21 and 25.

1.3 Recognition

In this context, recognition simply means incorporation of the item in the business's accounts, in this case as a non-current asset. The recognition of property, plant and equipment depends on two criteria.

(a) It is probable that **future economic benefits** associated with the asset will flow to the entity
(b) The cost of the asset to the entity can be **measured reliably**

These recognition criteria apply to **subsequent expenditure** as well as costs incurred initially. There are no separate criteria for recognising subsequent expenditure.

Property, plant and equipment can amount to **substantial amounts** in financial statements, affecting the presentation of the company's financial position and the profitability of the entity, through depreciation and also if an asset is wrongly classified as an expense and taken to profit or loss.

1.3.1 First criterion: future economic benefits

The **degree of certainty** attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should be assured that it will receive the rewards attached to the asset and it will incur the associated risks, which will only generally be the case when the rewards and risks have actually passed to the entity. Until then, the asset should not be recognised.

1.3.2 Second criterion: cost measured reliably

It is generally easy to measure the cost of an asset as the **transfer amount on purchase**, ie what was paid for it. **Self-constructed assets** can also be measured easily by adding together the purchase price of all the constituent parts (labour, material etc) paid to external parties.

1.4 Separate items

Most of the time assets will be identified individually, but this will not be the case for **smaller items**, such as tools, dies and moulds, which are sometimes classified as inventory and written off as an expense.

Major components or spare parts, however, should be recognised as property, plant and equipment.

For very **large and specialised items**, an apparently single asset should be broken down into its composite parts. This occurs where the different parts have different useful lives and different depreciation rates are applied to each part, eg an aircraft, where the body and engines are separated as they have different useful lives.

1.5 Safety and environmental equipment

These items may be necessary for the entity to **obtain future economic benefits** from its other assets. For this reason they are recognised as assets. However the original assets plus the safety equipment should be reviewed for impairment.

1.6 Initial measurement

Once an item of property, plant and equipment qualifies for recognition as an asset, it will initially be **measured at cost**.

1.6.1 Components of cost

The standard lists the components of the cost of an item of property, plant and equipment.

- **Purchase price**, less any trade discount or rebate
- **Import duties** and non-refundable purchase taxes
- **Directly attributable costs** of bringing the asset to working condition for its intended use, eg:
  – The cost of site preparation
  – Initial delivery and handling costs
  – Installation costs
  – Testing
  – Professional fees (architects, engineers)
- **Initial estimate** of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located

The revised IAS 16 provides **additional guidance on directly attributable** costs included in the cost of an item of property, plant and equipment.

(a) These costs bring the asset to the location and working conditions necessary for it to be capable of operating in the manner intended by management, including those costs to test whether the asset is functioning properly.

(b) They are determined after deducting the net proceeds from selling any items produced when bringing the asset to its location and condition.

The revised standard also states that income and related expenses of operations that are **incidental** to the construction or development of an item of property, plant and equipment should be **recognised** in profit or loss.

The following costs **will not be part of the cost** of property, plant or equipment unless they can be attributed directly to the asset's acquisition, or bringing it into its working condition.

- Administration and other general overhead costs
- Start-up and similar pre-production costs
- Initial operating losses before the asset reaches planned performance

All of these will be recognised as an **expense** rather than an asset.

In the case of **self-constructed assets**, the same principles are applied as for acquired assets. If the entity makes similar assets during the normal course of business for sale externally, then the cost of the asset will be the cost of its production under IAS 2 *Inventories*. This also means that abnormal costs (wasted material, labour or other resources) are excluded from the cost of the asset. An example of a self-constructed asset is when a building company builds its own head office.

1.6.2 Subsequent expenditure

Parts of some items of property, plant and equipment may require replacement at regular intervals. IAS 16 gives examples of a furnace which may require relining after a specified number of hours or aircraft interiors which may require replacement several times during the life of the aircraft.

This cost is recognised in full when it is incurred and added to the carrying amount of the asset. It will be depreciated over its expected life, which may be different from the expected life of the other components of the asset. The carrying amount of the item being replaced, such as the old furnace lining, is derecognised when the replacement takes place.

Expenditure incurred in replacing or renewing a component of an item of property, plant and equipment must be **recognised in the carrying amount of the item**. The carrying amount of the replaced or renewed component must be derecognised. A similar approach is also applied when a separate component of an item of property, plant and equipment is identified in respect of a major inspection to enable the continued use of the item.

1.6.3 Exchanges of assets

IAS 16 specifies that exchange of items of property, plant and equipment, regardless of whether the assets are similar, are measured at **fair value**, **unless the exchange transaction lacks commercial substance** or the fair value of neither of the assets exchanged can be **measured reliably**. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

1.7 Measurement subsequent to initial recognition

The standard offers two possible treatments here, essentially a choice between keeping an asset recorded at **cost** or revaluing it to **fair value**.

(a) **Cost model.** Carry the asset at its cost less depreciation and any accumulated impairment loss.

(b) **Revaluation model.** Carry the asset at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. The revised IAS 16 makes clear that the **revaluation model is available only if the fair value of the item can be measured reliably**.

1.7.1 Revaluations

The **market value** of land and buildings usually represents fair value, assuming existing use and line of business. Such valuations are usually carried out by professionally qualified valuers.

In the case of **plant and equipment**, fair value can also be taken as **market value**. Where a market value is not available, however, depreciated replacement cost should be used. There may be no market value where types of plant and equipment are sold only rarely or because of their specialised nature (ie they would normally only be sold as part of an ongoing business).

The frequency of valuation depends on the **volatility of the fair values** of individual items of property, plant and equipment. The more volatile the fair value, the more frequently revaluations should be carried out. Where the current fair value is very different from the carrying value then a revaluation should be carried out.

Most importantly, when an item of property, plant and equipment is revalued, **the whole class of assets to which it belongs should be revalued.**

All the items within a class should be **revalued at the same time**, to prevent selective revaluation of certain assets and to avoid disclosing a mixture of costs and values from different dates in the financial statements. A rolling basis of revaluation is allowed if the revaluations are kept up to date and the revaluation of the whole class is completed in a short period of time.

How should any **increase in value** be treated when a revaluation takes place? The debit will be the increase in value in the statement of financial position, but what about the credit? IAS 16 requires the increase to be credited to a **revaluation surplus** (ie part of owners' equity), *unless* the increase is reversing a previous decrease which was recognised as an expense. To the extent that this offset is made, the increase is recognised as income; any excess is then taken to the revaluation surplus.

1.8 Example: revaluation surplus

Binkie Co has an item of land carried in its books at $13,000. Two years ago a slump in land values led the company to reduce the carrying value from $15,000. This was taken as an expense in profit or loss. There has been a surge in land prices in the current year, however, and the land is now worth $20,000.

Account for the revaluation in the current year.

Solution

The double entry is:

DEBIT	Asset value (statement of financial position)	$7,000	
CREDIT	Profit or loss		$2,000
	Revaluation surplus		$5,000

Note: The credit to the revaluation surplus will be shown under 'other comprehensive income'.

The case is similar for a **decrease in value** on revaluation. Any decrease should be recognised as an expense, except where it offsets a previous increase taken as a revaluation surplus in owners' equity. Any decrease greater than the previous upwards increase in value must be taken as an expense in the profit or loss.

1.9 Example: revaluation decrease

Let us simply swap round the example given above. The original cost was $15,000, revalued upwards to $20,000 two years ago. The value has now fallen to $13,000.

Account for the decrease in value.

Solution

The double entry is:

DEBIT	Revaluation surplus	$5,000	
DEBIT	Profit or loss	$2,000	
CREDIT	Asset value (statement of financial position)		$7,000

There is a further complication when a **revalued asset is being depreciated**. As we have seen, an upward revaluation means that the depreciation charge will increase. Normally, a revaluation surplus is only realised when the asset is sold, but when it is being depreciated, part of that surplus is being realised as the asset is used. The amount of the surplus realised is the difference between depreciation charged on the revalued amount and the (lower) depreciation which would have been charged on the asset's original cost. **This amount can be transferred to retained (ie realised) earnings but NOT through profit or loss.**

1.10 Example: revaluation and depreciation

Crinckle Co bought an asset for $10,000 at the beginning of 20X6. It had a useful life of five years. On 1 January 20X8 the asset was revalued to $12,000. The expected useful life has remained unchanged (ie three years remain).

Account for the revaluation and state the treatment for depreciation from 20X8 onwards.

Solution

On 1 January 20X8 the carrying value of the asset is $10,000 – (2 × $10,000 ÷ 5) = $6,000. For the revaluation:

DEBIT	Accumulated depreciation	$4,000	
DEBIT	Asset value	$2,000	
CREDIT	Revaluation surplus		$6,000

The depreciation for the next three years will be $12,000 ÷ 3 = $4,000, compared to depreciation on cost of $10,000 ÷ 5 = $2,000. So each year, the extra $2,000 can be treated as part of the surplus which has become realised:

DEBIT	Revaluation surplus	$2,000	
CREDIT	Retained earnings		$2,000

This is a movement on owners' equity only, not an item in profit or loss.

Exam focus point

Note that when a revaluation takes place, the depreciation for the period up to the date of revaluation should be deducted from the carrying value **before** calculating the revaluation surplus. The examinations team has drawn attention to this as an error frequently made in exams.

1.11 Depreciation

The standard states:

- The **depreciable amount** of an item of property, plant and equipment should be allocated on a systematic basis over its useful life.
- The **depreciation method** used should reflect the pattern in which the asset's economic benefits are consumed by the entity.
- The **depreciation charge** for each period should be recognised as an expense unless it is included in the carrying amount of another asset.

Land and buildings are dealt with separately even when they are acquired together because land normally has an unlimited life and is therefore not depreciated. In contrast buildings do have a limited life and must be depreciated. Any increase in the value of land on which a building is standing will have no impact on the determination of the building's useful life.

1.11.1 Review of useful life

A review of the **useful life** of property, plant and equipment should be carried out **at least at each financial year end** and the depreciation charge for the current and future periods should be adjusted if expectations have changed significantly from previous estimates. Changes are changes in accounting estimates and are accounted for prospectively as adjustments to future depreciation.

1.11.2 Example: review of useful life

B Co acquired a non-current asset on 1 January 20X2 for $80,000. It had no residual value and a useful life of ten years.

On 1 January 20X5 the remaining useful life was reviewed and revised to four years.

What will be the depreciation charge for 20X5?

Solution

	$
Original cost	80,000
Depreciation 20X2 – 20X4 (80,000 × 3/10)	(24,000)
Carrying amount at 31 December 20X4	56,000
Remaining life	4 years
Depreciation charge years 20X5 – 20X8 (56,000/4)	14,000

1.11.3 Review of depreciation method

The **depreciation method** should also be reviewed **at least at each financial year end** and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method should be changed to suit this changed pattern. When such a change in depreciation method takes place the change should be accounted for as a **change in accounting estimate** and the depreciation charge for the current and future periods should be adjusted.

1.11.4 Impairment of asset values

An **impairment loss** should be treated in the same way as a **revaluation decrease** ie the decrease should be **recognised as an expense**. However, a revaluation decrease (or impairment loss) should be charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation surplus in respect of that same asset.

A **reversal of an impairment** loss should be treated in the same way as a **revaluation increase**, ie a revaluation increase should be recognised as income to the extent that it reverses a revaluation decrease or an impairment loss of the same asset previously recognised as an expense.

1.12 Complex assets

These are assets which are made up of separate components. Each component is separately depreciated over their useful life. An example which appeared in a recent examination was that of an aircraft. An aircraft could be considered as having the following components:

	Cost *$'000*	*Useful life*
Fuselage	20,000	20 years
Undercarriage	5,000	500 landings
Engines	8,000	1,600 flying hours

Depreciation at the end of the first year , in which 150 flights totalling 400 hours were made would then be:

	$'000
Exterior structure	1,000
Undercarriage (5,000 × 150/500)	1,500
Engines (8,000 × 400/1,600)	2,000
	4,500

1.13 Overhauls

Where an asset requires regular overhauls in order to continue to operate, the cost of the overhaul is treated as an additional component and depreciated over the period to the next overhaul.

In the case of the aircraft above, we will assume that an overhaul is required at the end of year 3 and every third year thereafter at a cost of $1.2m. This is capitalised as a separate component. The depreciation for year 4 (assuming 150 flights again) will therefore be:

	$'000
Total as above	4,500
Overhaul ($1,200,000 / 3)	400
	4,900

1.14 Retirements and disposals

When an asset is permanently **withdrawn from use, or sold or scrapped**, and no future economic benefits are expected from its disposal, it should be withdrawn from the statement of financial position.

Gains or losses are the difference between the estimated net disposal proceeds and the carrying amount of the asset. They should be recognised as income or expense in profit or loss.

1.15 Derecognition

An entity is required to **derecognise the carrying amount** of an item of property, plant or equipment that it disposes of on the date the **criteria for the sale of goods** in IAS 18 *Revenue* would be met. This also applies to parts of an asset.

An entity cannot classify as revenue a gain it realises on the disposal of an item of property, plant and equipment.

1.16 Disclosure

The standard has a long list of disclosure requirements, for each class of property, plant and equipment.

(a) **Measurement bases** for determining the gross carrying amount (if more than one, the gross carrying amount for that basis in each category)

(b) **Depreciation methods** used

(c) **Useful lives** or depreciation rates used

(d) **Gross carrying amount** and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period

(e) **Reconciliation** of the carrying amount at the beginning and end of the period showing:

   (i) Additions
   (ii) Disposals
   (iii) Acquisitions through business combinations
   (iv) Increases/decreases during the period from revaluations and from impairment losses
   (v) Impairment losses recognised in profit or loss
   (vi) Impairment losses reversed in profit or loss
   (vii) Depreciation
   (viii) Net exchange differences (from translation of statements of a foreign entity)
   (ix) Any other movements.

The financial statements should also disclose the following.

(a) Any recoverable amounts of property, plant and equipment
(b) Existence and amounts of **restrictions on title**, and items pledged as security for liabilities
(c) Accounting policy for **the estimated costs of restoring the site**
(d) Amount of expenditures on account of **items in the course of construction**
(e) Amount of commitments to **acquisitions**

Revalued assets require further disclosures.

(a) Basis used to revalue the assets
(b) Effective date of the revaluation
(c) Whether an independent valuer was involved
(d) Nature of any indices used to determine replacement cost
(e) Carrying amount of each class of property, plant and equipment that would have been included in the financial statements had the assets been carried at cost less accumulated depreciation and accumulated impairment losses.
(f) Revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders.

The standard also **encourages disclosure** of additional information, which the users of financial statements may find useful.

(a) The carrying amount of temporarily idle property, plant and equipment
(b) The gross carrying amount of any fully depreciated property, plant and equipment that is still in use
(c) The carrying amount of property, plant and equipment retired from active use and held for disposal
(d) The fair value of property, plant and equipment when this is materially different from the carrying amount

The following format (with notional figures) is commonly used to disclose non-current assets movements.

	Total	*Land and buildings*	*Plant and equipment*
	$	$	$
Cost or valuation			
At 1 January 20X4	50,000	40,000	10,000
Revaluation surplus	12,000	12,000	–
Additions in year	4,000	–	4,000
Disposals in year	(1,000)	–	(1,000)
At 31 December 20X4	65,000	52,000	13,000
Depreciation			
At 1 January 20X4	16,000	10,000	6,000
Charge for year	4,000	1,000	3,000
Eliminated on disposals	(500)	–	(500)
At 31 December 20X4	19,500	11,000	8,500
Net book value			
At 31 December 20X4	45,500	41,000	4,500
At 1 January 20X4	34,000	30,000	4,000

Question

Non-current assets

(a) In a statement of financial position prepared in accordance with IAS 16, what does the carrying amount represent?

(b) In a set of financial statements prepared in accordance with IAS 16, is it correct to say that the carrying amount in a statement of financial position cannot be greater than the market (net realisable) value of the partially used asset as at the end of the reporting period? Explain your reasons for your answer.

Answer

(a) In simple terms the carrying amount of an asset is the cost of an asset less the 'accumulated depreciation', that is, all depreciation charged so far. It should be emphasised that the main purpose of charging depreciation is to ensure that profits are fairly reported. Thus depreciation is concerned with the statement of profit or loss rather than the statement of financial position. In consequence the carrying amount in the statement of financial position can be quite arbitrary. In particular, it does not necessarily bear any relation to the market value of an asset and is of little use for planning and decision making.

An obvious example of the disparity between carrying amount and market value is found in the case of buildings, which may be worth more than ten times as much as their carrying amount.

(b) Carrying amount can in some circumstances be higher than market value (net realisable value). IAS 16 *Property, plant and equipment* states that the value of an asset cannot be greater than its 'recoverable amount'. However 'recoverable amount' as defined in IAS 16 is the amount recoverable from further use. This may be higher than the market value.

This makes sense if you think of a specialised machine which could not fetch much on the secondhand market but which will produce goods which can be sold at a profit for many years.

Exam focus point

Property and/or other non-current assets are likely to be tested as they have come up on virtually every exam paper.

2 Depreciation accounting

FAST FORWARD

Where assets held by an entity have a **limited useful life** to that entity it is necessary to apportion the value of an asset over it's useful life.

2.1 Non-current assets

If an asset's life extends over more than one accounting period, it earns profits over more than one period. It is a **non-current asset**.

With the exception of land held on freehold or very long leasehold, **every non-current asset eventually wears out over time**. Machines, cars and other vehicles, fixtures and fittings, and even buildings do not last for ever. When a business acquires a non-current asset, it will have some idea about how long its useful life will be, and it might decide what to do with it.

(a) Keep on using the non-current asset until it becomes **completely worn out**, useless, and worthless.

(b) **Sell off** the non-current asset at the end of its useful life, either by selling it as a second-hand item or as scrap.

Since a non-current asset has a cost, and a limited useful life, and its value eventually declines, it follows that a charge should be made in profit or loss to reflect the use that is made of the asset by the business. This charge is called **depreciation**.

2.2 Scope and definitions

Depreciation accounting is governed by IAS 16 *Property, plant and equipment*. These are some of the IAS 16 definitions concerning depreciation.

Key terms

- **Depreciation** is the result of systematic allocation of the depreciable amount of an asset over its estimated useful life. Depreciation for the accounting period is charged to net profit or loss for the period either directly or indirectly.
- **Depreciable assets** are assets which:
  - Are expected to be used during more than one accounting period
  - Have a limited useful life
  - Are held by an entity for use in the production or supply of goods and services, for rental to others, or for administrative purposes
- **Useful life** is one of two things.
  - The period over which a depreciable asset is expected to be used by the entity, or
  - The number of production or similar units expected to be obtained from the asset by the entity.
- **Depreciable amount** of a depreciable asset is the historical cost or other amount substituted for cost in the financial statements, less the estimated residual value.

(IAS 16)

An 'amount substituted for cost' will normally be a **current market value** after a revaluation has taken place.

2.3 Depreciation

IAS 16 requires the depreciable amount of a depreciable asset to be allocated on a **systematic basis** to each accounting period during the useful life of the asset. **Every part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item must be depreciated separately**.

One way of defining depreciation is to describe it as a means of **spreading the cost** of a non-current asset over its useful life, and so matching the cost against the full period during which it earns profits for the business. Depreciation charges are an example of the application of the accrual assumption to calculate profits.

There are situations where, over a period, an asset has **increased in value**, ie its current value is greater than the carrying value in the financial statements. You might think that in such situations it would not be necessary to depreciate the asset. The standard states, however, that this is irrelevant, and that depreciation should still be charged to each accounting period, based on the depreciable amount, irrespective of a rise in value.

An entity is required to begin depreciating an item of property, plant and equipment when it is available for use and to continue depreciating it until it is derecognised even if it is idle during the period.

2.4 What is depreciation?

The need to depreciate non-current assets arises from the **accruals assumption**. If money is expended in purchasing an asset then the amount expended must at some time be charged against profits. If the asset is one which contributes to an entity's revenue over a number of accounting periods it would be inappropriate to charge any single period (eg the period in which the asset was acquired) with the whole of the expenditure. Instead, some method must be found of spreading the cost of the asset over its useful economic life.

This view of depreciation as a process of allocation of the cost of an asset over several accounting periods is the view adopted by IAS 16. It is worth mentioning here two **common misconceptions** about the purpose and effects of depreciation.

(a) It is sometimes thought that the carrying amount of an asset is equal to its net realisable value and that the object of charging depreciation is to **reflect the fall in value of an asset over its life**. This misconception is the basis of a common, but incorrect, argument which says that freehold properties (say) need not be depreciated in times when property values are rising. It is true that historical cost statements of financial position often give a misleading impression when a property's carrying amount is much below its market value, but in such a case it is open to a business to incorporate a revaluation into its books, or even to prepare its accounts based on current costs. This is a separate problem from that of allocating the property's cost over successive accounting periods.

(b) Another misconception is that depreciation is provided **so that an asset can be replaced at the end of its useful life**. This is not the case.

    (i) If there is no intention of replacing the asset, it could then be argued that there is no need to provide for any depreciation at all.

    (ii) If prices are rising, the replacement cost of the asset will exceed the amount of depreciation provided.

2.5 Useful life

The following factors should be considered when **estimating the useful life** of a depreciable asset.

- Expected **physical wear and tear**
- **Obsolescence**
- Legal or other **limits** on the use of the assets

Once decided, the useful life should be **reviewed at least every financial year end** and depreciation rates adjusted for the current and future periods if expectations vary significantly from the original estimates. The effect of the change should be disclosed in the accounting period in which the change takes place.

The assessment of useful life requires **judgement** based on previous experience with similar assets or classes of asset. When a completely new type of asset is acquired (ie through technological advancement or through use in producing a brand new product or service) it is still necessary to estimate useful life, even though the exercise will be much more difficult.

The standard also points out that the physical life of the asset might be longer than its useful life to the entity in question. One of the main factors to be taken into consideration is the **physical wear and tear** the asset is likely to endure. This will depend on various circumstances, including the number of shifts for which the asset will be used, the entity's repair and maintenance programme and so on. Other factors to be considered include obsolescence (due to technological advances/improvements in production/ reduction in demand for the product/service produced by the asset) and legal restrictions, eg length of a related lease.

2.6 Residual value

In most cases the residual value of an asset is **likely to be immaterial**. If it is likely to be of any significant value, that value must be estimated at the date of purchase or any subsequent revaluation. The amount of residual value should be estimated based on the current situation with other similar assets, used in the same way, which are now at the end of their useful lives. Any expected costs of disposal should be offset against the gross residual value.

2.7 Depreciation methods

Consistency is important. The depreciation method selected should be applied consistently from period to period unless altered circumstances justify a change. When the method *is* changed, the effect should be quantified and disclosed and the reason for the change should be stated.

Various methods of allocating depreciation to accounting periods are available, but whichever is chosen must be applied **consistently** (as required by IAS 1: see Chapter 2), to ensure comparability from period to period. Change of policy is not allowed simply because of the profitability situation of the entity.

You should be familiar with the various **accepted methods of allocating depreciation** and the relevant calculations and accounting treatments, which are revised in questions at the end of this section.

2.8 Disclosure

An accounting policy note should disclose the **valuation bases** used for determining the amounts at which depreciable assets are stated, along with the other accounting policies: see IAS 1.

IAS 16 also requires the following to be disclosed for each major class of depreciable asset.

- **Depreciation methods** used
- **Useful lives** or the depreciation rates used
- **Total depreciation** allocated for the period
- **Gross amount** of depreciable assets and the related accumulated depreciation

The following questions are for revision purposes only.

Question

A lorry bought for a business cost $17,000. It is expected to last for five years and then be sold for scrap for $2,000. Usage over the five years is expected to be:

Year 1	200 days
Year 2	100 days
Year 3	100 days
Year 4	150 days
Year 5	40 days

Required

Work out the depreciation to be charged each year under:

(a) The straight line method
(b) The reducing balance method (using a rate of 35%)
(c) The machine hour method
(d) The sum-of-the digits method

Answer

(a) Under the straight line method, depreciation for each of the five years is:

Annual depreciation = $\frac{\$(17{,}000-2{,}000)}{5}$ = $3,000

(b) Under the reducing balance method, depreciation for each of the five years is:

Year	*Depreciation*		
1	35% × $17,000	=	$5,950
2	35% × ($17,000 – $5,950) = 35% × $11,050	=	$3,868
3	35% × ($11,050 – $3,868) = 35% × $7,182	=	$2,514
4	35% × ($7,182 – $2,514) = 35% × $4,668	=	$1,634
5	Balance to bring book value down to $2,000 = $4,668 – $1,634 – $2,000	=	$1,034

(c) Under the machine hour method, depreciation for each of the five years is calculated as follows.

Total usage (days) = 200 + 100 + 100 + 150 + 40 = 590 days

Depreciation per day = $\frac{\$(17{,}000-2{,}000)}{590}$ = $25.42

Year	*Usage (days)*	*Depreciation ($) (days × $25.42)*
1	200	5,084.00
2	100	2,542.00
3	100	2,542.00
4	150	3,813.00
5	40	1,016.80
		14,997.80

Note. The answer does not come to exactly $15,000 because of the rounding carried out at the 'depreciation per day' stage of the calculation.

(d) The sum-of-the digits method begins by adding up the years of expected life. In this case, 5 + 4 + 3 + 2 + 1 = 15.

The depreciable amount of $15,000 will then be allocated as follows:

Year	1	15,000 × 5/15 = 5,000
	2	15,000 × 4/15 = 4,000
	3	15,000 × 3/15 = 3,000
	4	15,000 × 2/15 = 2,000
	5	15,000 × 1/15 = 1,000

Exam focus point

The December 2011 and the June 2012 exams both had questions which included depreciation.

Question

Depreciation discussion

(a) What are the purposes of providing for depreciation?

(b) In what circumstances is the reducing balance method more appropriate than the straight-line method? Give reasons for your answer.

Answer

(a) The accounts of a business try to recognise that the cost of a non-current asset is gradually consumed as the asset wears out. This is done by gradually writing off the asset's cost to profit or loss over several accounting periods. This process is known as depreciation, and is an example of the accruals assumption. IAS 16 *Property, plant and equipment* requires that depreciation should be allocated on a systematic basis to each accounting period during the useful life of the asset.

With regard to the accrual principle, it is fair that the profits should be reduced by the depreciation charge; this is not an arbitrary exercise. Depreciation is not, as is sometimes supposed, an attempt to set aside funds to purchase new non-current assets when required. Depreciation is not generally provided on freehold land because it does not 'wear out' (unless it is held for mining etc).

(b) The reducing balance method of depreciation is used instead of the straight line method when it is considered fair to allocate a greater proportion of the total depreciable amount to the earlier years and a lower proportion to the later years on the assumption that the benefits obtained by the business from using the asset decline over time.

In favour of this method it may be argued that it links the depreciation charge to the costs of maintaining and running the asset. In the early years these costs are low and the depreciation charge is high, while in later years this is reversed.

Question

Depreciation accounting

A business purchased two rivet-making machines on 1 January 20X5 at a cost of $15,000 each. Each had an estimated life of five years and a nil residual value. The straight line method of depreciation is used.

Owing to an unforeseen slump in market demand for rivets, the business decided to reduce its output of rivets, and switch to making other products instead. On 31 March 20X7, one rivet-making machine was sold (on credit) to a buyer for $8,000.

Later in the year, however, it was decided to abandon production of rivets altogether, and the second machine was sold on 1 December 20X7 for $2,500 cash.

Prepare the machinery account, provision for depreciation of machinery account and disposal of machinery account for the accounting year to 31 December 20X7.

Answer

MACHINERY ACCOUNT

		$			$
20X7			*20X7*		
1 Jan	Balance b/f	30,000	31 Mar	Disposal of machinery account	15,000
			1 Dec	Disposal of machinery account	15,000
		30,000			30,000

ACCUMULATED DEPRECIATION OF MACHINERY

		$			$
20X7			*20X7*		
31 Mar	Disposal of machinery account*	6,750	1 Jan	Balance b/f	12,000
1 Dec	Disposal of machinery account**	8,750	31 Dec	Profit or loss***	3,500
		15,500			15,500

* Depreciation at date of disposal = $6,000 + $750

** Depreciation at date of disposal = $6,000 + $2,750

*** Depreciation charge for the year = $750 + $2,750

DISPOSAL OF MACHINERY

		$			$
20X7			*20X7*		
31 Mar	Machinery account	15,000	31 Mar	Account receivable (sale price)	8,000
			31 Mar	Provision for depreciation	6,750
1 Dec	Machinery	15,000	1 Dec	Cash (sale price)	2,500
			1 Dec	Provision for depreciation	8,750
			31 Dec	Profit or loss (loss on disposal)	4,000
		30,000			30,000

You should be able to calculate that there was a loss on the first disposal of $250, and on the second disposal of $3,750, giving a total loss of $4,000.

Workings

1 At 1 January 20X7, accumulated depreciation on the machines will be:

2 machines × 2 years × $\frac{\$15,000}{5}$ per machine pa = $12,000, or $6,000 per machine

2 Monthly depreciation is $\frac{\$3,000}{12}$ = $250 per machine per month

3 The machines are disposed of in 20X7.

(a) On 31 March – after three months of the year. Depreciation for the year on the machine = 3 months × $250 = $750.

(b) On 1 December – after 11 months of the year. Depreciation for the year on the machine = 11 months × $250 = $2,750

3 IAS 20 Government grants

FAST FORWARD

It is common for entities to receive government grants for various purposes (grants may be called subsidies, premiums, etc). They may also receive other types of assistance which may be in many forms.

3.1 Scope

The treatment of government grants is covered by IAS 20 *Accounting for government grants and disclosure of government assistance.*

IAS 20 does ***not*** cover the following situations.

- Accounting for government grants in financial statements reflecting the effects of **changing prices**
- Government assistance given in the form of **'tax breaks'**
- Government acting as **part-owner** of the entity

3.2 Definitions

These definitions are given by the standard.

Key terms

- **Government.** Government, government agencies and similar bodies whether local, national or international.
- **Government assistance.** Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.
- **Government grants.** Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.
- **Grants related to assets**. Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.
- **Grants related to income**. Government grants other than those related to assets.
- **Forgivable loans.** Loans which the lender undertakes to waive repayment of under certain prescribed conditions. *(IAS 20)*
- **Fair value**. The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *(IFRS 13)*

You can see that there are many **different forms** of government assistance: both the type of assistance and the conditions attached to it will vary. Government assistance may have encouraged an entity to undertake something it otherwise would not have done.

How will the receipt of government assistance affect the financial statements?

(a) An appropriate method must be found to account for any **resources transferred**.

(b) The extent to which an entity has **benefited** from such assistance during the reporting period should be shown.

3.3 Government grants

An entity should not recognise government grants (including non-monetary grants at fair value) until it has **reasonable assurance** that:

- The entity will comply with any **conditions** attached to the grant
- The entity will **actually receive** the grant

Even if the grant has been received, this does not prove that the conditions attached to it have been or will be fulfilled.

It makes no difference in the treatment of the grant whether it is received in cash or given as a reduction in a liability to government, ie the **manner of receipt is irrelevant**.

Any related **contingency** should be recognised under IAS 37 *Provisions, contingent liabilities and contingent assets*, once the grant has been recognised.

In the case of a **forgivable loan** (as defined in key terms above) from government, it should be treated in the same way as a government grant when it is reasonably assured that the entity will meet the relevant terms for forgiveness.

3.3.1 Accounting treatment of government grants

IAS 20 requires grants to be recognised as income over the relevant periods to match them with related costs which they have been received to compensate. This should be done on a systematic basis. **Grants should not, therefore, be credited directly to equity.**

It would be against the accruals assumption to credit grants to income on a receipts basis, so a **systematic basis of matching** must be used. A receipts basis would only be acceptable if no other basis was available.

It will usually be easy to identify the **costs related to a government grant**, and thereby the period(s) in which the grant should be recognised as income, ie when the costs are incurred. Where grants are received in relation to a depreciating asset, the grant will be recognised over the periods in which the asset is depreciated *and* in the same proportions.

Question — Recognition

Arturo Co receives a government grant representing 50% of the cost of a depreciating asset which costs $40,000. How will the grant be recognised if Arturo Co depreciates the asset:

(a) over four years straight line; or
(b) at 40% reducing balance?

The residual value is nil. The useful life is four years.

Answer

The grant should be recognised in the same proportion as the depreciation.

(a) Straight line

	Depreciation	*Grant income*
	$	$
Year 1	10,000	5,000
2	10,000	5,000
3	10,000	5,000
4	10,000	5,000

(b) Reducing balance

	Depreciation	*Grant income*
	$	$
Year 1	16,000	8,000
2	9,600	4,800
3	5,760	2,880
4 (remainder)	8,640	4,320

In the case of **grants for non-depreciable assets**, certain obligations may need to be fulfilled, in which case the grant should be recognised as income over the periods in which the cost of meeting the obligation is incurred. For example, if a piece of land is granted on condition that a building is erected on it, then the grant should be recognised as income over the building's life.

There may be a **series of conditions** attached to a grant, in the nature of a package of financial aid. An entity must take care to identify precisely those conditions which give rise to costs which in turn determine the periods over which the grant will be earned. When appropriate, the grant may be split and the parts allocated on different bases.

An entity may receive a grant as compensation for expenses or losses which it has **already incurred**. Alternatively, a grant may be given to an entity simply to provide immediate financial support where no future related costs are expected. In cases such as these, the grant received should be recognised as income of the period in which it becomes receivable.

3.3.2 Non-monetary government grants

A non-monetary asset may be transferred by government to an entity as a grant, for example a piece of land, or other resources. The **fair value** of such an asset is usually assessed and this is used to account for both the asset and the grant. Alternatively, both may be valued at a nominal amount.

3.3.3 Presentation of grants related to assets

There are two choices here for how government grants related to assets (including non-monetary grants at fair value) should be shown in the statement of financial position.

(a) Set up the grant as **deferred income.**

(b) **Deduct the grant** in arriving at the **carrying amount** of the asset.

These are considered to be acceptable alternatives. Whichever of these methods is used, the **cash flows** in relation to the purchase of the asset and the receipt of the grant are often disclosed separately because of the significance of the movements in cash flow.

Example: accounting for grants related to assets

A company receives a 20% grant towards the cost of a new item of machinery, which cost $100,000. The machinery has an expected life of four years and a nil residual value. The expected profits of the company, before accounting for depreciation on the new machine or the grant, amount to $50,000 per annum in each year of the machinery's life.

Solution

The results of the company for the four years of the machine's life would be as follows.

(a) *Reducing the cost of the asset*

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Total*
	$	$	$	$	$
Profit before depreciation	50,000	50,000	50,000	50,000	200,000
Depreciation*	20,000	20,000	20,000	20,000	80,000
Profit	30,000	30,000	30,000	30,000	120,000

*The depreciation charge on a straight line basis, for each year, is ¼ of $(100,000 – 20,000) = $20,000.

Statement of financial position at year end (extract)

	$	$	$	$
Non-current asset	80,000	80,000	80,000	80,000
Depreciation 25%	20,000	40,000	60,000	80,000
Carrying amount	60,000	40,000	20,000	–

(b) *Treating the grant as deferred income*

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Total*
	$	$	$	$	$
Profit as above	50,000	50,000	50,000	50,000	200,000
Depreciation	(25,000)	(25,000)	(25,000)	(25,000)	(100,000)
Grant	5,000	5,000	5,000	5,000	20,000
Profit	30,000	30,000	30,000	30,000	120,000

Statement of financial position at year end (extract)

	Year 1	*Year 2*	*Year 3*	*Year 4*
	$	$	$	$
Non-current asset at cost	100,000	100,000	100,000	100,000
Depreciation 25%	(25,000)	(50,000)	(75,000)	(100,000)
Carrying amount	75,000	50,000	25,000	–
Government grant deferred income	15,000	10,000	5,000	–

Whichever of these methods is used, the **cash flows** in relation to the purchase of the asset and the receipt of the grant are often disclosed separately because of the significance of the movements in cash flow.

Deducting the grant from the cost of the asset is simpler, but the deferred income method has the advantage that the non-current asset continues to be carried at cost in the financial statements.

3.3.4 Presentation of grants related to income

These grants are a credit in profit or loss, but there is a choice in the method of disclosure.

(a) Present as a **separate credit** or under a general heading, eg 'other income'
(b) **Deduct from the related expense**

Some would argue that offsetting income and expenses in the statement of profit or loss is not good practice. Others would say that the expenses would not have been incurred had the grant not been available, so offsetting the two is acceptable. Although both methods are acceptable, disclosure of the grant may be necessary for a **proper understanding** of the financial statements, particularly the effect on any item of income or expense which is required to be separately disclosed.

3.3.5 Repayment of government grants

If a grant must be repaid it should be accounted for as a **revision of an accounting estimate** (see IAS 8).

(a) **Repayment of a grant related to income:** apply first against any unamortised deferred income set up in respect of the grant; any excess should be recognised immediately as an expense.
(b) **Repayment of a grant related to an asset**: increase the carrying amount of the asset or reduce the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised to date in the absence of the grant should be immediately recognised as an expense.

It is possible that the circumstances surrounding repayment may require a review of the **asset value** and an impairment of the new carrying amount of the asset.

3.4 Government assistance

Some forms of government assistance are excluded from the definition of government grants.

(a) Some forms of government assistance **cannot reasonably have a value placed on them**, eg free technical or marketing advice, provision of guarantees.
(b) There are transactions with government which **cannot be distinguished from the entity's normal trading transactions**, eg government procurement policy resulting in a portion of the entity's sales. Any segregation would be arbitrary.

Disclosure of such assistance may be necessary because of its significance; its nature, extent and duration should be disclosed. Loans at low or zero interest rates are a form of government assistance, but the imputation of interest does not fully quantify the benefit received.

3.5 Disclosure

Disclosure is required of the following.

- **Accounting policy** adopted, including method of presentation
- **Nature and extent** of government grants recognised and other forms of assistance received
- **Unfulfilled conditions and other contingencies** attached to recognised government assistance

4 IAS 40 Investment property

FAST FORWARD

An entity may own land or a building **as an investment** rather than for use in the business. It may therefore generate cash flows largely independently of other assets which the entity holds. The treatment of investment property is covered by IAS 40.

4.1 Definitions

Consider the following definitions.

Key terms

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) Use in the production or supply of goods or services or for administrative purposes, or
(b) Sale in the ordinary course of business

Owner-occupied property is property held by the owner (or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Carrying amount is the amount at which an asset is recognised in the statement of financial position.

A property interest that is held by a lessee under an **operating lease** may be classified and accounted for as an **investment property**, if and only if the property would otherwise meet the definition of an investment property and the lessee uses the IAS 40 **fair value model**. This classification is available on a property-by-property basis.

Examples of investment property include:

(a) **Land held for long-term capital appreciation** rather than for short-term sale in the ordinary course of business
(b) A **building** owned by the reporting entity (or held by the entity under a finance lease) and **leased out under an operating lease**
(c) A building held by a **parent** and leased to a **subsidiary**. Note, however, that while this is regarded as an investment property in the individual parent company financial statements, in the **consolidated** financial statements this property will be regarded as owner-occupied (because it is occupied by the group) and will therefore be treated in accordance with IAS 16.
(d) Property that is being constructed or developed for future use as an investment property

Question — **Investment**

Rich Co owns a piece of land. The directors have not yet decided whether to build a factory on it for use in its business or to keep it and sell it when its value has risen.

Would this be classified as an investment property under IAS 40?

Answer

Yes. If an entity has not determined that it will use the land either as an owner-occupied property or for short-term sale in the ordinary course of business, the land is considered to be held for capital appreciation.

4.2 IAS 40

IAS 40 *Investment property* was published in March 2000 and has recently been revised. Its objective is to prescribe the accounting treatment for investment property and related disclosure requirements.

The standard includes investment property held under a finance lease or leased out under an operating lease. However, the current IAS 40 does not deal with matters covered in IAS 17 *Leases.*

You now know what **is** an investment property under IAS 40. Below are examples of items that are **not investment property.**

Type of non-investment property	Applicable IAS
Property intended for sale in the ordinary course of business	IAS 2 *Inventories*
Property being constructed or developed on behalf of third parties	IAS 11 *Construction contracts*
Owner-occupied property	IAS 16 *Property, plant and equipment*

4.3 Recognition

Investment property should be recognised as an asset when **two conditions** are met.

(a) It is **probable** that the **future economic benefits** that are associated with the investment property will **flow to the entity**.

(b) The **cost** of the investment property can be **measured reliably**.

4.4 Initial measurement

An investment property should be measured initially at its **cost,** including transaction costs.

A property interest held under a lease and classified as an investment property shall be accounted for **as if it were a finance lease**. The asset is recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount is recognised as a liability.

4.5 Measurement subsequent to initial recognition

IAS 40 requires an entity to **choose between two models.**

- The fair value model
- The cost model

Whatever policy it chooses should be applied to **all of its investment property**.

Where an entity chooses to classify a property held under an **operating lease** as an investment property, there is **no choice**. The **fair value model must be used** for **all the entity's investment property**, regardless of whether it is owned or leased.

4.5.1 Fair value model

Key term

(a) After initial recognition, an entity that chooses the **fair value model** should measure all of its investment property at fair value, except in the extremely rare cases where this cannot be measured reliably. In such cases it should apply the IAS 16 cost model.

(b) A gain or loss arising from a change in the fair value of an investment property should be recognised in net profit or loss for the period in which it arises.

(c) The fair value of investment property should reflect market conditions at the end of the reporting period.

Unusually, the IASB allows a fair value model for non-financial assets. This is not the same as a revaluation, where increases in carrying amount above a cost-based measure are recognised as revaluation surplus. Under the fair-value model all changes in fair value are recognised in profit or loss.

IFRS 13 *Fair value measurement,* issued in May 2011 deleted much of the guidance provided in IAS 40 in respect of the determination of fair value. Instead the requirements of IFRS 13 (see Chapter 11) apply in measuring the fair value of investment properties. This standard requires that the following are considered in determining fair value:

(a) The asset being measured

(b) The principal market (ie that where the most activity takes place) or where there is no principal market, the most advantageous market (ie that in which the best price could be achieved) in which an orderly transaction would take place for the asset

(c) The highest and best use of the asset and whether it is used on a stand-alone basis or in conjunction with other assets

(d) Assumptions that market participants would use when pricing the asset.

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that level 1 inputs are used where possible:

Level 1 Quoted prices in active markets for identical assets that the entity can access at the measurement date.

Level 2 Inputs other than quoted prices that are directly or indirectly observable for the asset.

Level 3 Unobservable inputs for the asset.

More detail

Level 1 inputs are prices quoted in active markets for items identical to the asset (in this case investment property) being measured. Active markets are ones where transactions take place with sufficient frequency and volume for pricing information to be provided.

In general, IFRS 13 requires in respect of non-financial assets that fair value is decided on the basis of the **highest and best use of the asset as determined by a market participant**. Highest and best use is determined from the perspective of market participants, even if the reporting entity intends a different use. For example, an entity may intend to use assets acquired in a business combination differently from how other market participants might use them. If, however, there is no evidence to suggest that the current use of an asset is not its highest and best use an entity does not need to carry out an exhaustive search for other potential uses.

The 'highest and best use' requirement would appear not to contradict point (b) below, because it requires a market participant rather than solely the knowledge of the entity.

KPMG *(Real Estate Newsletter, July 2011),* has expressed the opinion that the 'highest and best use' requirement is unlikely to change the valuation of investment property:

> 'The real estate sector is used to dealing with alternative use value. For example an existing commercial property which could generate additional value through conversion into a residential development would be valued based on the higher amount if there is reasonable certainty over the planning being gained.'

More detail on IFRS 13 is given in Chapter 11.

The guidance which remains in IAS 40 is as follows.

(a) Double counting should be prevented in deciding on the fair value of the assets. For example, elevators or air conditioning, which form an integral part of a building should be incorporated in the investment property rather than recognised separately.

(b) According to the definition in **IAS 36** *Impairment of assets,* fair value is not the same as 'value in use'. The latter reflects factors and knowledge as relating solely to the entity, while the former reflects factors and knowledge applicable to the market.

(c) In those uncommon cases in which the **fair value of an investment property cannot be measured reliably** by an entity, the cost model in **IAS 16** must be employed until the investment property is disposed of. **The residual value must be assumed to be zero**.

4.5.2 Cost model

The cost model is the **cost model in IAS 16**. Investment property should be measured at **depreciated cost, less any accumulated impairment losses**. An entity that chooses the cost model should **disclose the fair value of its investment property**.

4.5.3 Changing models

Once the entity has chosen the fair value or cost model, it should apply it to all its investment property. It **should not change from one model to the other unless the change will result in a more appropriate presentation**. IAS 40 states that it is highly unlikely that a change from the fair value model to the cost model will result in a more appropriate presentation.

4.6 Transfers

Transfers to or from investment property should **only** be made **when there is a change in use**. For example, owner occupation commences so the investment property will be treated under IAS 16 as an owner-occupied property.

When there is a transfer from investment property carried at fair value to owner-occupied property or inventories, the property's cost for subsequent accounting under IAS 16 or IAS 2 should be its fair value at the date of change of use.

Conversely, an owner-occupied property may become an investment property and need to be carried at fair value. An entity should apply IAS 16 up to the date of change of use. It should treat any difference at that date between the carrying amount of the property under IAS 16 and its fair value as a revaluation under IAS 16.

4.7 Worked example: Transfer to investment property

A business owns a building which it has been using as a head office. In order to reduce costs, on 30 June 20X9 it moved its head office functions to one of its production centres and is now letting out its head office. Company policy is to use the fair value model for investment property.

The building had an original cost on 1 January 20X0 of $250,000 and was being depreciated over 50 years. At 31 December 20X9 its fair value was judged to be $350,000.

How will this appear in the financial statements at 31 December 20X9?

Solution

The building will be depreciated up to 30 June 20X9.

	$
Original cost	250,000
Depreciation 1.1.X0 – 1.1.X9 (250/50 × 9)	(45,000)
Depreciation to 30.6.X9 (250/50 × 6/12)	(2,500)
Carrying amount at 30.6.X9	202,500
Revaluation surplus	147,500
Fair value at 30.6.X9	350,000

The difference between the carrying amount and fair value is taken to a **revaluation surplus** in accordance with IAS 16.

However the building will be subjected to a fair value exercise at each year end and these gains or losses will go to **profit or loss**. If at the end of the following year the fair value of the building is found to be $380,000, $30,000 will be credited to profit or loss.

4.8 Disposals

Derecognise (eliminate from the statement of financial position) an investment property on disposal or when it is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Any **gain or loss** on disposal is the difference between the net disposal proceeds and the carrying amount of the asset. It should generally be **recognised as income or expense in profit or loss.**

Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable.

4.9 Disclosure requirements

These relate to:

- Choice of fair value model or cost model
- Whether property interests held as operating leases are included in investment property
- Criteria for classification as investment property
- Assumptions in determining fair value
- Use of independent professional valuer (encouraged but not required)
- Rental income and expenses
- Any restrictions or obligations

4.9.1 Fair value model – additional disclosures

An entity that adopts this must also disclose a **reconciliation** of the carrying amount of the investment property at the beginning and end of the period.

4.9.2 Cost model – additional disclosures

These relate mainly to the depreciation method. In addition, an entity which adopts the cost model **must disclose the fair value** of the investment property.

5 IAS 23 Borrowing costs

FAST FORWARD

IAS 23 looks at the treatment of **borrowing costs**, particularly where the related borrowings are applied to the construction of certain assets. These are what are usually called 'self-constructed assets', where an entity builds its own inventory or non-current assets over a substantial period of time.

5.1 Definitions

IAS 23 *Borrowing costs* was revised in March 2007. Previously it gave a choice of methods in dealing with borrowing costs: capitalisation or expense. The revised standard requires capitalisation.

Only two definitions are given by the standard.

Key terms

Borrowing costs. Interest and other costs incurred by an entity in connection with the borrowing of funds.

Qualifying asset. An asset that necessarily takes a substantial period of time to get ready for its intended use or sale. *(IAS 23)*

The standard lists what may be **included in borrowing costs**.

- Interest on bank overdrafts and short-term and long-term borrowings
- Amortisation of discounts or premiums relating to borrowings
- Amortisation of ancillary costs incurred in connection with the arrangement of borrowings
- Finance charges in respect of finance leases recognised in accordance with IAS 17
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs

Depending on the circumstances, any of the following may be qualifying assets.

- Inventories
- Manufacturing plants
- Power generation facilities
- Intangible assets
- Investment properties

Financial assets and inventories that are manufactured, or otherwise produced over a short period of time are **not qualifying assets**. Assets that are ready for their intended use or sale when purchased are not qualifying assets.

5.2 IAS 23 revised: capitalisation

Under the revised treatment, all eligible borrowing costs must be **capitalised**.

Only borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset can be capitalised as part of the cost of that asset. The standard lays out the criteria for determining which borrowing costs are eligible for capitalisation.

5.2.1 Borrowing costs eligible for capitalisation

Those borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset must be identified. These are the borrowing costs that **would have been avoided** had the expenditure on the qualifying asset not been made. This is obviously straightforward where funds have been borrowed for the financing of one particular asset.

Difficulties arise, however, where the entity uses a **range of debt instruments** to finance a wide range of assets, so that there is no direct relationship between particular borrowings and a specific asset. For example, all borrowings may be made centrally and then lent to different parts of the group or entity. Judgement is therefore required, particularly where further complications can arise (eg foreign currency loans).

Once the relevant borrowings are identified, which relate to a specific asset, then the **amount of borrowing costs available for capitalisation** will be the actual borrowing costs incurred on those borrowings during the period, *less* any investment income on the temporary investment of those borrowings. It would not be unusual for some or all of the funds to be invested before they are actually used on the qualifying asset.

Question

On 1 January 20X6 Stremans Co borrowed $1.5m to finance the production of two assets, both of which were expected to take a year to build. Work started during 20X6. The loan facility was drawn down and incurred on 1 January 20X6, and was utilised as follows, with the remaining funds invested temporarily.

	Asset A	*Asset B*
	$'000	$'000
1 January 20X6	250	500
1 July 20X6	250	500

The loan rate was 9% and Stremans Co can invest surplus funds at 7%.

Required

Ignoring compound interest, calculate the borrowing costs which may be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X6.

Answer

		Asset A	*Asset B*
		$	$
Borrowing costs			
To 31 December 20X6	$500,000/$1,000,000 × 9%	45,000	90,000
Less investment income			
To 30 June 20X6	$250,000/$500,000 × 7% × 6/12	(8,750)	(17,500)
		36,250	72,500
Cost of assets			
Expenditure incurred		500,000	1,000,000
Borrowing costs		36,250	72,500
		536,250	1,072,500

Exam focus point

The June 2013 exam included a seven mark question part on borrowing costs, but with a twist: the asset was being constructed jointly with another investor. Being a joint operation, 50% of the borrowing cost was recognised in the financial statements.

In a situation where **borrowings are obtained generally**, but are applied in part to obtaining a qualifying asset, then the amount of borrowing costs eligible for capitalisation is found by applying the 'capitalisation rate' to the expenditure on the asset.

The **capitalisation rate** is the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, *excluding* borrowings made specifically to obtain a qualifying asset. However, there is a cap on the amount of borrowing costs calculated in this way: it must not exceed actual borrowing costs incurred.

Sometimes one overall weighted average can be calculated for a group or entity, but in some situations it may be more appropriate to use a weighted average for borrowing costs for **individual parts of the group or entity**.

Question

Acruni Co had the following loans in place at the beginning and end of 20X6.

	1 January 20X6	*31 December 20X6*
	$m	$m
10% Bank loan repayable 20X8	120	120
9.5% Bank loan repayable 20X9	80	80
8.9% debenture repayable 20X7	–	150

The 8.9% debenture was issued to fund the construction of a qualifying asset (a piece of mining equipment), construction of which began on 1 July 20X6.

On 1 January 20X6, Acruni Co began construction of a qualifying asset, a piece of machinery for a hydro-electric plant, using existing borrowings. Expenditure drawn down for the construction was: $£30m on 1 January 20X6, $20m on 1 October 20X6.

Required

Calculate the borrowing costs that can be capitalised for the hydro-electric plant machine.

Answer

Capitalisation rate = weighted average rate = $(10\% \times \frac{120}{120+80}) + (9.5\% \times \frac{80}{120+80}) = 9.8\%$

Borrowing costs = ($30m × 9.8%) + ($20m × 9.8% × 3/12)
= $3.43m

5.2.2 Carrying amount exceeds recoverable amount

As a result of capitalising borrowing costs, a situation may arise whereby the carrying amount (or expected ultimate cost) of the qualifying asset exceeds its recoverable amount or net realisable value. In these cases, the carrying amount must be **written down or written off**, as required by other IASs. In certain circumstances (again as allowed by other IASs), these amounts may be written back in future periods.

5.2.3 Commencement of capitalisation

Three events must be taking place for capitalisation of borrowing costs to be started.

(a) Expenditure on the asset is being incurred
(b) Borrowing costs are being incurred
(c) Activities are in progress that are necessary to prepare the asset for its intended use or sale

Expenditure must result in the payment of cash, transfer of other assets or assumption of interest-bearing liabilities. **Deductions from expenditure** will be made for any progress payments or grants received in connection with the asset. IAS 23 allows the **average carrying amount** of the asset during a period (including borrowing costs previously capitalised) to be used as a reasonable approximation of the expenditure to which the capitalisation rate is applied in the period. Presumably more exact calculations can be used.

Activities necessary to prepare the asset for its intended sale or use extend further than physical construction work. They encompass technical and administrative work prior to construction, eg obtaining permits. They do *not* include holding an asset when no production or development that changes the asset's condition is taking place, eg where land is held without any associated development activity.

5.2.4 Suspension of capitalisation

If active development is **interrupted for any extended periods**, capitalisation of borrowing costs should be suspended for those periods.

Suspension of capitalisation of borrowing costs is not necessary for **temporary delays** or for periods when substantial technical or administrative work is taking place.

5.2.5 Cessation of capitalisation

Once substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete, then capitalisation of borrowing costs should cease. This will normally be when **physical construction of the asset is completed**, although minor modifications may still be outstanding.

The asset may be completed in **parts or stages**, where each part can be used while construction is still taking place on the other parts. Capitalisation of borrowing costs should cease for each part as it is completed. The example given by the standard is a business park consisting of several buildings.

5.2.6 Disclosure

The following should be disclosed in the financial statements in relation to borrowing costs.

(a) Amount of borrowing costs **capitalised during the period**

(b) **Capitalisation rate** used to determine the amount of borrowing costs eligible for capitalisation

Chapter Roundup

- IAS 16 covers all aspects of accounting for property, plant and equipment. This represents the bulk of items which are **'tangible' non-current assets**.
- Where assets held by an entity have a **limited useful life** to that entity it is necessary to apportion the value of an asset over its useful life.
- It is common for entities to receive government grants for various purposes (grants may be called subsidies, premiums, etc). They may also receive other types of assistance which may be in many forms.
- An entity may own land or a building **as an investment** rather than for use in the business. It may therefore generate cash flows largely independently of other assets which the entity holds. The treatment of investment property is covered by IAS 40.
- IAS 23 looks at the treatment of **borrowing costs**, particularly where the related borrowings are applied to the construction of certain assets. These are what are usually called 'self-constructed assets,' where an entity builds its own inventory or non-current assets over a substantial period of time.

Quick Quiz

1 Define depreciation.

2 Which of the following elements can be included in the production cost of a non-current asset?

(i) Purchase price of raw materials
(ii) Architect's fees
(iii) Import duties
(iv) Installation costs

3 Market value can usually be taken as fair value.

True ☐

False ☐

4 Investment properties must always be shown at fair value.

True ☐

False ☐

5 What is the correct treatment for property being constructed for future use as investment property?

Answers to Quick Quiz

1 See Para 2.2
2 All of them.
3 True, but see IFRS 13 for more detail
4 False. The cost model may be used, provided it is used consistently.
5 It is treated as an investment property under IAS 40.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q7	Examination	20	36 mins

Impairment of assets

5

Topic list	Syllabus reference
1 IAS 36 Impairment of assets	B3
2 Cash generating units	B3
3 Goodwill and the impairment of assets	B3
4 Accounting treatment of an impairment loss	B3

Introduction

IAS 36 is an important standard. Impairment rules apply to both tangible and intangible assets.

Study guide

B3	**Impairment of assets**
(a)	Define the recoverable amount of an asset; define impairment losses
(b)	Give examples of, and be able to identify, circumstances that may indicate that an impairment of an asset has occurred
(c)	Describe what is meant by a cash-generating unit
(d)	State the basis on which impairment losses should be allocated, and allocate a given impairment loss to the assets of a cash-generating unit.

1 IAS 36 Impairment of assets

FAST FORWARD

Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its **fair value less costs to sell** and its **value in use**.

There is an established principle that assets should not be carried at above their recoverable amount. An entity should write down the carrying value of an asset to its recoverable amount if the carrying value of an asset is not recoverable in full. IAS 36 puts in place a detailed methodology for carrying out impairment reviews and related accounting treatments and disclosures.

1.1 Scope

IAS 36 applies to all tangible, intangible and financial assets except inventories, assets arising from construction contracts, deferred tax assets, assets arising under IAS 19 *Employee benefits* and financial assets within the scope of IAS 32 *Financial instruments: presentation*. This is because those IASs already have rules for recognising and measuring impairment. Note also that IAS 36 does not apply to non-current assets held for sale, which are dealt with under IFRS 5 *Non-current assets held for sale and discontinued operations*

Key terms

- **Impairment**: A fall in the value of an asset, so that its 'recoverable amount' is now less than its carrying value in the statement of financial position.
- **Carrying amount**: is the net value at which the asset is included in the statement of financial position (ie after deducting accumulated depreciation and any impairment losses).

(IAS 36)

The basic principle underlying IAS 36 is relatively straightforward. If an asset's value in the accounts is higher than its realistic value, measured as its 'recoverable amount', the asset is judged to have suffered an impairment loss. It should therefore be reduced in value, by the amount of the **impairment loss**. The amount of the impairment loss should be **written off against profit** immediately.

The main accounting issues to consider are therefore:

(a) How is it possible to **identify when** an impairment loss may have occurred?
(b) How should the **recoverable amount** of the asset be measured?
(c) How should an 'impairment loss' be **reported in the accounts**?

1.2 Identifying a potentially impaired asset

An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. The concept of **materiality** applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the entity is required to make a formal estimate of the **recoverable amount** of the assets concerned.

IAS 36 suggests how **indications of a possible impairment** of assets might be recognised. The suggestions are based largely on common sense.

(a) **External sources of information**

 (i) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use.

 (ii) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.

 (iii) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.

 (iv) The carrying amount of the entity's net assets being more than its market capitalisation.

(b) **Internal sources of information**: evidence of obsolescence or physical damage, adverse changes in the use to which the asset is put, or the asset's economic performance

Even if there are no indications of impairment, the following assets must **always** be tested for impairment annually.

(a) An intangible asset with an **indefinite useful life**
(b) **Goodwill** acquired in a business combination

1.3 Measuring the recoverable amount of the asset

What is an asset's recoverable amount?

Key term

The **recoverable amount of an asset** should be measured as the HIGHER VALUE of:

(a) The asset's fair value less costs to sell; and
(b) Its value in use. *(IAS 36)*

An asset's fair value less costs to sell is the amount net of selling costs that could be obtained from the sale of the asset. Selling costs include sales transaction costs, such as legal expenses.

(a) If there is **an active market** in the asset, the net selling price should be based on the **market value**, or on the price of recent transactions in similar assets.

(b) If there is **no active market** in the assets it might be possible to **estimate** a net selling price using best estimates of what 'knowledgeable, willing parties' might pay in an arm's length transaction.

Net selling price **cannot** be reduced, however, by including within selling costs any **restructuring or reorganisation expenses**, or any costs that have already been recognised in the accounts as liabilities.

The concept of 'value in use' is very important.

Key term

The **value in use** of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its expected useful life.

1.4 Recognition and measurement of an impairment loss

The rule for assets at historical cost is:

Rule to learn

If the recoverable amount of an asset is lower than the carrying amount, the carrying amount should be reduced by the difference (ie the impairment loss) which should be charged as an expense in profit or loss.

The rule for assets held at a revalued amount (such as property revalued under IAS 16) is:

Rule to learn

The impairment loss is to be treated as a revaluation decrease under the relevant IAS.

In practice this means:

- To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to revaluation surplus.
- Any excess should be charged to profit or loss.

2 Cash generating units

FAST FORWARD

When it is not possible to calculate the recoverable amount of a single asset, then that of its **cash generating unit** should be measured instead.

2.1 Use of cash-generating unit

The IAS goes into quite a large amount of detail about the important concept of cash generating units. As a basic rule, the recoverable amount of an asset should be calculated for the **asset individually**. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows and outflows cannot be attributed to the individual asset.

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's cash-generating unit should be measured instead.

Key term

A **cash-generating unit** is the smallest identifiable group of assets for which independent cash flows can be identified and measured.

Question — **Cash-generating unit I**

Can you think of some examples of how a cash-generating unit would be identified?

Answer

Here are two possibilities.

(a) A mining company owns a private railway that it uses to transport output from one of its mines. The railway now has no market value other than as scrap, and it is impossible to identify any separate cash inflows with the use of the railway itself. Consequently, if the mining company suspects an impairment in the value of the railway, it should treat the mine as a whole as a cash generating unit, and measure the recoverable amount of the mine as a whole.

(b) A bus company has an arrangement with a town's authorities to run a bus service on four routes in the town. Separately identifiable assets are allocated to each of the bus routes, and cash inflows and outflows can be attributed to each individual route. Three routes are running at a profit and one is running at a loss. The bus company suspects that there is an impairment of assets on the loss-making route. However, the company will be unable to close the loss-making route, because it is under an obligation to operate all four routes, as part of its contract with the local authority. Consequently, the company should treat all four bus routes together as a cash generating unit, and calculate the recoverable amount for the unit as a whole.

Question

Minimart belongs to a retail store chain Maximart. Minimart makes all its retail purchases through Maximart's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring Minimart's cashiers and salesmen) are decided by Maximart. Maximart also owns five other stores in the same city as Minimart (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as Minimart. Minimart and four other stores were purchased five years ago and goodwill was recognised.

What is the cash-generating unit for Minimart?

Answer

In identifying Minimart's cash-generating unit, an entity considers whether, for example:

(a) Internal management reporting is organised to measure performance on a store-by-store basis.
(b) The business is run on a store-by-store profit basis or on a region/city basis.

All Maximart's stores are in different neighbourhoods and probably have different customer bases. So, although Minimart is managed at a corporate level, Minimart generates cash inflows that are largely independent from those of Maximart's other stores. Therefore, it is likely that Minimart is a cash-generating unit.

If an active market exists for the output produced by the asset or a group of assets, this asset or group should be identified as a cash generating unit, even if some or all of the output is used internally.

Cash-generating units should be identified consistently from period to period for the same type of asset unless a change is justified.

The group of net assets less liabilities that are considered for impairment should be the same as those considered in the calculation of the recoverable amount. (For the treatment of goodwill and corporate assets see below.)

2.2 Example: Recoverable amount and carrying amount

Fourways Co is made up of four cash generating units. All four units are being tested for impairment. Assets and liabilities will be allocated to them as follows:

(a) Property, plant and equipment and separate intangibles will be allocated to the cash-generating units as far as possible.
(b) Current assets such as inventories, receivables and prepayments will be allocated to the relevant cash-generating units.
(c) Liabilities (eg payables) will be deducted from the net assets of the relevant cash-generating units.
(d) The net figure for each cash-generating unit resulting from this exercise will be compared to the relevant recoverable amount, computed on the same basis.

3 Goodwill and the impairment of assets

3.1 Allocating goodwill to cash-generating units

Goodwill acquired in a business combination does not generate cash flows independently of other assets. It must be **allocated** to each of the acquirer's **cash-generating units** (or groups of cash-generating units) that are expected to benefit from the synergies of the combination. Each unit to which the goodwill is so allocated should:

(a) Represent the **lowest level** within the entity at which the goodwill is monitored for internal management purposes

(b) Not be **larger than a reporting segment** determined in accordance with IFRS 8 *Operating segments*.

It may be impracticable to complete the allocation of goodwill before the first reporting date after a business combination, particularly if the acquirer is accounting for the combination for the first time using provisional values. The initial allocation of goodwill must be completed before the end of the first reporting period after the acquisition date.

3.2 Testing cash-generating units with goodwill for impairment

A cash-generating unit to which goodwill has been allocated is tested for impairment annually. The **carrying amount** of the unit, including goodwill, is **compared with the recoverable amount**. If the carrying amount of the unit exceeds the recoverable amount, the entity must recognise an impairment loss.

The annual impairment test may be performed at any time during an accounting period, but must be performed at the **same time every year**.

3.3 Example: allocation of impairment loss

A cash-generating unit comprises the following:

	\$m
Building	30
Plant and equipment	6
Goodwill	10
Current assets	20
	66

Following a recession, an impairment review has estimated the recoverable amount of the cash-generating unit to be \$50m.

How do we allocate the impairment loss?

The loss will be applied first against the goodwill and then against the tangible non-current assets on a pro-rata basis.

	Carrying amount	*Impairment loss*	*Carrying amount post- impairment*
	\$m	\$	\$
Building	30	(5)	25
Plant and equipment	6	(1)	5
Goodwill	10	(10)	–
Current assets	20	–	20
	66	(16)	50

4 Accounting treatment of an impairment loss

If, and only if, the recoverable amount of an asset is less than its carrying amount in the statement of financial position, an impairment loss has occurred. This loss should be **recognised immediately**.

(a) The asset's **carrying amount** should be reduced to its recoverable amount in the statement of financial position.

(b) The **impairment loss** should be recognised immediately in profit or loss (unless the asset has been revalued in which case the loss is treated as a revaluation decrease).

After reducing an asset to its recoverable amount, the **depreciation charge** on the asset should then be based on its new carrying amount, its estimated residual value (if any) and its estimated remaining useful life.

An impairment loss should be recognised for a **cash - generating unit** if (and only if) the recoverable amount for the cash- generating unit is less than the carrying amount in the statement of financial position for all the assets in the unit. When an impairment loss is recognised for a cash- generating unit, the loss should be allocated between the assets in the unit in the following order.

(a) First, to any assets that are obviously damaged or destroyed
(b) Next, to the **goodwill** allocated to the cash generating unit
(c) Then to all other assets in the cash-generating unit, on a **pro rata basis**

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

(a) Its fair value less costs to sell
(b) Its value in use (if determinable)
(c) Zero

Any remaining amount of an impairment loss should be recognised as a liability if required by other IASs.

4.1 Example 1: impairment loss

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

(a) Its carrying amount in the statement of financial position is $3m.
(b) The company has received an offer of $2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.
(c) The present value of the estimated cash flows from the platform's continued use is $3.3m (before adjusting for dismantling costs).
(d) The carrying amount in the statement of financial position for the provision for dismantling and removal is currently $0.6m.

What should be the value of the drilling platform in the statement of financial position, and what, if anything, is the impairment loss?

Solution

Fair value less costs to sell	=	$2.8m
Value in use	=	PV of cash flows from use less the carrying amount of the provision/liability = $3.3m – $0.6m = $2.7m
Recoverable amount	=	Higher of these two amounts, ie $2.8m
Carrying value	=	$3m
Impairment loss	=	$0.2m

The carrying value should be reduced to $2.8m

4.2 Example 2: impairment loss

A company has acquired another business for $4.5m: tangible assets are valued at $4.0m and goodwill at $0.5m.

An asset with a carrying value of $1m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to assess whether there has been an impairment of assets in the acquired business and what the amount of any such loss is.

The recoverable amount of the business (a single cash generating unit) is measured as $3.1m.

Solution

There has been an impairment loss of \$1.4m (\$4.5m – \$3.1m).

The impairment loss will be recognised in profit or loss. The loss will be allocated between the assets in the cash generating unit as follows.

(a) A loss of \$1m can be attributed directly to the uninsured asset that has been destroyed.
(b) The remaining loss of \$0.4m should be allocated to goodwill.

The carrying value of the assets will now be \$3m for tangible assets and \$0.1m for goodwill.

4.3 Reversal of an impairment loss

The annual assessment to determine whether there may have been some impairment should be **applied to all assets**, including assets that have already been impaired in the past.

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be **higher** than the asset's current carrying value. In other words, there might have been a reversal of some of the previous impairment loss.

(a) The reversal of the impairment loss should be **recognised immediately** as income in profit or loss.
(b) The carrying amount of the asset should be increased to its **new recoverable amount**.

An exception to this rule is for **goodwill**. An impairment loss for goodwill should not be reversed in a subsequent period.

Question — Reversal of impairment loss

A cash generating unit comprising a factory, plant and equipment etc and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash generating unit falls to \$60m, resulting in an impairment loss of \$80m, allocated as follows.

	Carrying amounts before impairment	*Carrying amounts after impairment*
	\$m	\$m
Goodwill	40	–
Patent (with no market value)	20	–
Tangible non-current assets (market value \$60m)	80	60
Total	140	60

After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the cash generating unit increases to \$90m. The carrying amount of the tangible non-current assets had the impairment not occurred would have been \$70m.

Required

Calculate the reversal of the impairment loss.

Answer

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible non-current assets to what it would have been had the impairment not taken place, ie a reversal of the impairment loss of \$10m is recognised and the tangible non-current assets written back to \$70m. Reversal of the impairment is not recognised in relation to the goodwill and patent because the effect of the external event that caused the original impairment has not reversed – the original product is still overtaken by a more advanced model.

Exam focus point

An exam question may ask you to calculate and allocate an impairment loss. Make sure you know the order in which to allocate the loss.

4.4 Summary

The main aspects of IAS 36 to consider are:

- **Indications** of impairment of assets
- **Measuring recoverable amount**, as net selling price or value in use
- **Measuring value in use**
- **Cash generating units**
- **Accounting treatment** of an impairment loss, for individual assets and cash generating units
- **Reversal** of an impairment loss

Chapter Roundup

- Impairment is determined by comparing the carrying amount of the asset with its recoverable amount. This is the higher of its **fair value less costs to sell** and its **value in use**.
- When it is not possible to calculate the recoverable amount of a single asset, then that of its **cash – generating unit** should be measured instead.

Quick Quiz

1 Define **recoverable amount** of an asset.

2 How is an impairment loss on a revalued asset treated?

3 How is an impairment loss allocated to the assets in a cash-generating unit?

Answers to Quick Quiz

1 Higher of **fair value less costs to sell** and **value in use**.

2 As a revaluation decrease.

3 In the following order: a) against any damaged or destroyed assets; then b) against goodwill; then c) against all other assets on a *pro rata* basis.

6

Leases

Topic list	Syllabus reference
1 Types of lease	B4
2 Lessee accounting	B4
3 Lessor accounting	B4
4 Criticism and proposed changes	B4

Introduction

Leasing transactions are extremely common so this is an important practical subject. **Lease accounting is regulated by IAS 17**, which was introduced because of abuses in the use of lease accounting by companies.

These companies effectively 'owned' an asset and 'owed' a debt for its purchase, but showed neither the asset nor the liability in the statement of financial position because they were not required to do so.

You should be familiar with the more straightforward aspects of this topic from your earlier studies, but we will go through these aspects in full as leasing can be very complicated. The first section of this chapter goes over some of that basic groundwork, before the chapter moves on to more complicated aspects.

Study guide

B4	**Leases**
(a)	Define the essential characteristics of a lease
(b)	Describe and apply the method of determining a lease type (ie an operating or finance lease)
(c)	Explain the effect on the financial statements of a finance lease being incorrectly treated as an operating lease
(d)	Account for operating leases in financial statements of the lessor and lessee
(e)	Account for finance leases in the financial statements of the lessor and lessee
(f)	Outline the principles of accounting standards for leases and the main disclosure requirements. Note: the net cash investment method will not be examined.

1 Types of lease

FAST FORWARD

IAS 17 covers the accounting under lease transactions for both lessees and lessors.

There are **two forms of lease**:

- Finance leases
- Operating leases

Exam focus point

You are likely to be asked about the detailed accounting treatment as well as for critical comment and discussion. Issues of faithful representation are a key area for this exam.

A **lease** is a contract between a lessee for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right of the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals. The term 'lease' also applies to other arrangements in which one party retains ownership of an asset but conveys the right to the use of the asset to another party for an agreed period of time in return for specified payments.

FAST FORWARD

The definition of a **finance lease** is very important: it is a lease that transfers all the risks and rewards of ownership of the asset, regardless of whether legal title passes.

Leasing can be considered, to be, like hire purchase, a form of instalment credit. Leases of this type are referred to as **finance leases**. Although there are many variations, in general a finance lease will have the following characteristics.

(a) The lease term will consist of a **primary period and a secondary period**. The primary period, which may be for three, four or five years, will be non-cancellable or cancellable only under certain conditions, for example on the payment of a heavy settlement figure. The secondary period is usually cancellable at any time at the lessee's option.

(b) The rentals payable during the primary period will be sufficient to **repay to the lessor** the cost of the equipment plus interest thereon.

(c) The rentals during the secondary period will be of a **nominal amount**.

(d) If the lessee wishes to **terminate the lease** during the secondary period, the equipment will be sold and substantially all of the sale proceeds will be paid to the lessee as a rebate of rentals.

(e) The lessee will be responsible for the **maintenance** and **insurance** of equipment throughout the lease.

It can be seen from the above that, from the point of view of the lessee, leasing an asset is very **similar to purchasing** it using a loan repayable over the primary period. The lessee has all of the benefits and responsibilities of ownership.

Other, leases are of a very different nature. For example, a businessman may decide to hire (lease) a car while his own is being repaired. A lease of this nature is for a short period of time compared with the car's useful life and the lessor will expect to lease it to many different lessees during that life. Furthermore, the lessor rather than the lessee will be responsible for maintenance. Agreements of this type are usually called **operating leases**.

IAS 17 *Leases* requires that different accounting treatments should be adopted for finance and operating leases. In distinguishing between them, IAS 17 gives the following definitions.

Key terms

Lease. An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Finance lease. A lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

Operating lease. A lease other than a finance lease. *(IAS 17)*

When we talk of **risks** here, we specifically mean the risks of ownership, not other types of risk. Risks of **ownership** include the possibility of losses from idle capacity or technological obsolescence, or variations in return due to changing economic conditions. The **rewards** are represented by the expectation of profitable operation over the asset's economic life, and also any gain from appreciation in value or realisation of a residual value.

IAS 17 applies the same definitions and accounting principles to both lessees and lessors, but the **different circumstances** of each may lead each to classify the same lease differently.

Classification is made at the **inception of the lease**. Any revised agreement should be treated as a new agreement over its term. In contrast, changes in estimates (eg of economic life or residual value of the property) or changes in circumstances (eg default by the lessee) do not lead to a new classification of a lease for accounting purposes.

Land normally has an indefinite economic life. If the lessee does not receive legal title by the end of the lease, then the lessee does not receive substantially all the risks and rewards of ownership of the land, in which case the lease of land will normally be an operating lease. Any premium paid for such a leasehold is effectively a prepayment of lease payments. These are amortised over the lease term according to the pattern of benefits provided.

Following the improvements to IFRS issued by the IASB in 2009, land held under a long lease may now be classified as a finance lease.

Where there is a lease of both land and buildings, the land and buildings elements are considered separately for the purpose of lease classification, unless title to both elements is expected to pass to the lessee by the end of the lease term (in which case both elements are classified as a financial lease). When the land has an indefinite economic life, the land element is classified as an operating lease unless title is expected to pass to the lessee by the end of the lease term; the buildings element is classified as a finance or operating lease.

Question — Finance lease

Given the above definition of a finance lease, can you think of examples of situations that would normally lead to a lease being classified as a finance lease?

Answer

Some of these (given by IAS 17) may seem fairly obvious, but others are quite complicated.

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term

(b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred

(d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset

(e) The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made

There are also some indicators of situations which individually or in combination could lead to a lease being classified as a finance lease.

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee

(b) Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (eg in the form of a rent rebate equalling most of the sales proceeds at the end of the lease)

(c) The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent

1.1 Other definitions

FAST FORWARD

Make sure you learn these **important definitions** from IAS 17:

- Minimum lease payments
- Interest rate implicit in the lease
- Guaranteed/unguaranteed residual values
- Gross net investments in the lease

IAS 17 gives a substantial number of definitions.

Key terms

Minimum lease payments. The payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and be reimbursable to the lessor, together with:

(a) For a lessee, any amounts guaranteed by the lessee or by a party related to the lessee

(b) For a lessor, any residual value guaranteed to the lessor by one of the following.

(i) The lessee
(ii) A party related to the lessee
(iii) An independent third party financially capable of meeting this guarantee

However, if the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it

Interest rate implicit in the lease.

The discount rate that, at the inception of the lease, causes the aggregate present value of

(a) The minimum lease payments, and
(b) The unguaranteed residual value

to be equal to the sum of

(a) The fair value of the leased asset, and
(b) Any initial direct costs.

Key terms (cont'd)

Initial direct costs are **incremental costs** that are directly attributable to **negotiating** and **arranging** a lease, except for such costs incurred by manufacturer or dealer lessors. Examples of initial direct costs include amounts such as **commissions, legal fees** and relevant internal costs.

Lease term. The non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

A non-cancellable lease is a lease that is cancellable only in one of the following situations.

(a) Upon the occurrence of some remote contingency

(b) With the permission of the lessor

(c) If the lessee enters into a new lease for the same or an equivalent asset with the same lessor

(d) Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain

The **inception of the lease** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

(a) a lease is classified as either an operating lease or a finance lease; and

(b) in the case of a finance lease, the amounts to be recognised at the lease term are determined.

Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users, or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

Useful life is the estimated remaining period, from the beginning of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Guaranteed residual value is:

(a) For a lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable)

(b) For a lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Gross investment in the lease is the aggregate of:

(a) The minimum lease payments receivable by the lessor under a finance lease, and

(b) Any unguaranteed residual value accruing to the lessor.

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between:

(a) The gross investment in the lease, and

(b) The net investment in the lease.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (eg percentage of sales, amount of usage, price indices, market rates of interest). *(IAS 17)*

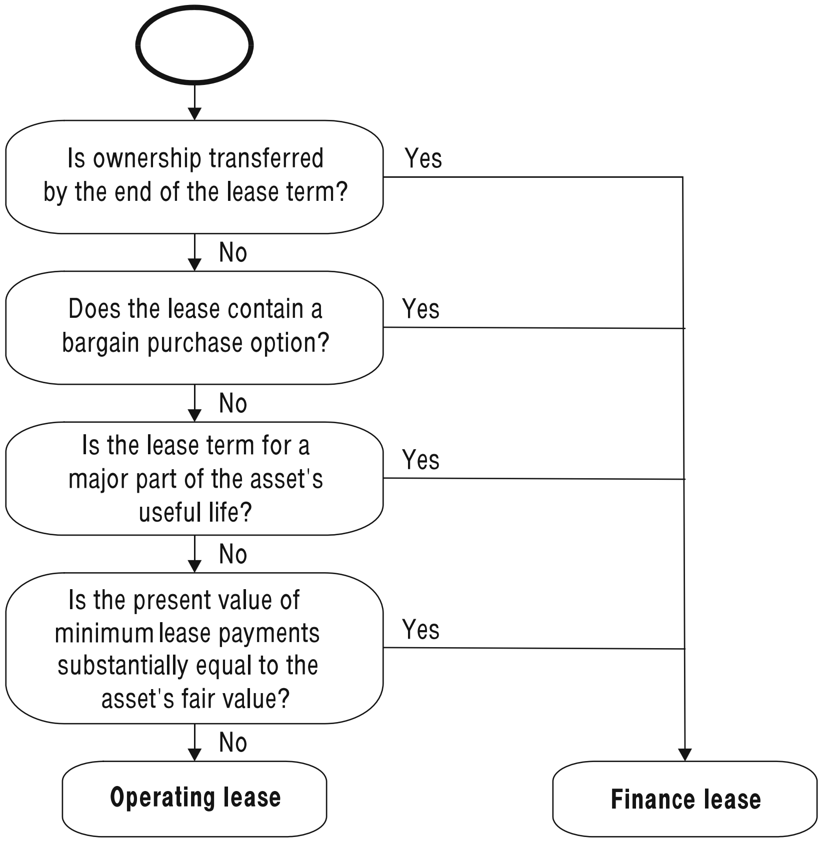
Some of these definitions are only of relevance once we look at lessor accounting in Section 3.

You should also note here that IAS 17 **does not apply to** either (a) or (b) below.

(a) Lease agreements to explore for or use of natural resources (eg oil, gas, timber).
(b) Licensing agreements for items such as motion picture films, plays, etc.

1.2 Section summary

The following summary diagram should help you when deciding whether a lease is an operating lease or a finance lease.



2 Lessee accounting

FAST FORWARD

Lessee accounting:

- **Finance leases:** record an asset in the statement of financial position and a liability to pay for it (fair value or PV of minimum lease payments), apportion the finance charge to give a constant periodic rate of return.
- **Operating leases:** write off rentals on a straight line basis.

2.1 Finance leases

From the lessee's point of view there are two main **accounting problems**.

(a) Whether the asset should be **capitalised** as if it had been purchased.
(b) How the **lease charges** should be allocated between different accounting periods.

2.1.1 Accounting treatment

IAS 17 requires that a finance lease should be recorded in the statement of financial position of a lessee as an asset and as an obligation to pay future lease payments. At the inception of the lease the sum to be recorded both as an asset and as a liability should be the **fair value of the leased property** or, if lower, at the **present value of the minimum lease payments**. The latter are derived by discounting them at the interest rate implicit in the lease.

If it is not practicable to determine the interest rate implied in the lease, then the lessee's **incremental borrowing rate** can be used.

Any **initial direct costs** of the lessee are added to the amount recognised as an asset. Such costs are often incurred in connection with securing or negotiating a lease. Only those costs which are directly attributable to activities performed by the lessee to obtain a finance lease should be added to the amount recognised as an asset.

IAS 17 states that it is not appropriate to show liabilities for leased assets as deductions from the leased assets. A distinction should be made between **current and non-current** lease liabilities, if the entity makes this distinction for other assets.

2.1.2 Lease payments

Minimum lease payments should be apportioned between the finance charge and a reduction of the outstanding obligation for future amounts payable. The total finance charge under a finance lease should be allocated to accounting periods during the lease term so as to produce a **constant periodic rate of interest** on the remaining balance of the obligation for each accounting period, or a reasonable approximation thereto.

Contingent rents should be charged in the periods in which they are incurred.

An asset leased under a finance lease should be **depreciated** over the shorter of the lease term or its useful life if there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term. The policy of depreciation adopted should be **consistent** with similar non-leased assets and calculations should follow the bases set out in IAS 16 (see Chapter 4).

IAS 17 introduced guidance on **impairment** of leased assets by referring to IAS 36.

2.1.3 Lessees' disclosure for finance leases

IAS 17 introduced substantial disclosures (in addition to those required by IFRS 7: see Chapter 11).

- The **net carrying amount** at the year end for each class of asset
- A **reconciliation** between the total of minimum lease payments at the year end, and their present value. In addition, an entity should disclose the total of minimum lease payments at the year end, and their present value, for each of the following periods:
  - Not later than one year
  - Later than one year and not later than five years
  - Later than five years
- **Contingent rents** recognised as an expense for the period
- Total of **future minimum sublease payments** expected to be received under non-cancellable subleases at the year end
- A **general description** of the lessee's significant leasing arrangements including, but not limited to, the following:
  - The basis on which contingent rent payments are determined
  - The existence and terms of renewal or purchase options and escalation clauses
  - Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing

2.1.4 Arguments against capitalisation

We have seen that the main argument in favour of capitalisation is substance over form. The main arguments **against** capitalisation are as follows.

(a) **Legal position.** The benefit of a lease to a lessee is an intangible asset, not the ownership of the equipment. It may be misleading to users of accounts to capitalise the equipment when a lease is legally quite different from a loan used to purchase the equipment. Capitalising leases also raises the question of whether other executory contracts should be treated similarly, for example contracts of employment.

(b) **Complexity**. Many small businesses will find that they do not have the expertise necessary for carrying out the calculations required for capitalisation.

(c) **Subjectivity**. To some extent, capitalisation is a somewhat arbitrary process and this may lead to a lack of consistency between companies.

(d) **Presentation**. The impact of leasing can be more usefully described in the notes to financial statements. These can be made readily comprehensible to users who may not understand the underlying calculations.

2.1.5 Allocating finance charge

There are two main ways of **allocating the finance charge** between accounting periods.

- Actuarial method (before tax)
- Sum of the digits method

Exam focus point

The sum of the digits method is not examinable.

The **actuarial method** is the best and most scientific method. It derives from the common-sense assumption that the interest charged by a lessor company will equal the rate of return desired by the company, multiplied by the amount of capital it has invested.

(a) At the beginning of the lease the capital invested is equal to the fair value of the asset (less any initial deposit paid by the lessee).

(b) This amount reduces as each instalment is paid. It follows that the interest accruing is greatest in the early part of the lease term, and gradually reduces as capital is repaid. In this section, we will look at a simple example of the actuarial method.

2.2 Example: Actuarial method

On 1 January 20X0 Bacchus Co, wine merchants, buys a small bottling and labelling machine from Silenus Co under a finance lease. The cash price of the machine was $7,710 while the amount to be paid was $10,000. The agreement required the immediate payment of a $2,000 deposit with the balance being settled in four equal annual instalments commencing on 31 December 20X0. The charge of $2,290 represents interest of 15% per annum, calculated on the remaining balance of the liability during each accounting period. Depreciation on the plant is to be provided for at the rate of 20% per annum on a straight line basis assuming a residual value of nil.

You are required to show the breakdown of each instalment between interest and capital, using the actuarial method.

Exam focus point

The rate of interest implicit in the lease would always be given in the exam if required

Solution

Interest is calculated as 15% of the outstanding *capital* balance at the beginning of each year.
The outstanding capital balance reduces each year by the capital element comprised in each instalment.
The outstanding capital balance at 1 January 20X0 is $5,710 ($7,710 fair value less $2,000 deposit).

	Total	*Capital*	*Interest*
	$	$	$
Capital balance at 1 Jan 20X0		5,710	
1st instalment			
(interest = $5,710 × 15%)	2,000	1,144	856
Capital balance at 1 Jan 20X1		4,566	
2nd instalment			
(interest = $4,566 × 15%)	2,000	1,315	685
Capital balance at 1 Jan 20X2		3,251	
3rd instalment			
(interest = $3,251 × 15%)	2,000	1,512	488
Capital balance at 1 Jan 20X3		1,739	
4th instalment			
(interest = $1,739 × 15%)	2,000	1,739	261
	8,000		2,290
Capital balance at 1 Jan 20X4		–	

2.3 Operating leases

IAS 17 requires that the **rentals** under operating leases should be written off as an expense on a **straight line basis** over the lease term even if the payments are not made on such a basis, unless another systematic and rational basis is justified by the circumstances.

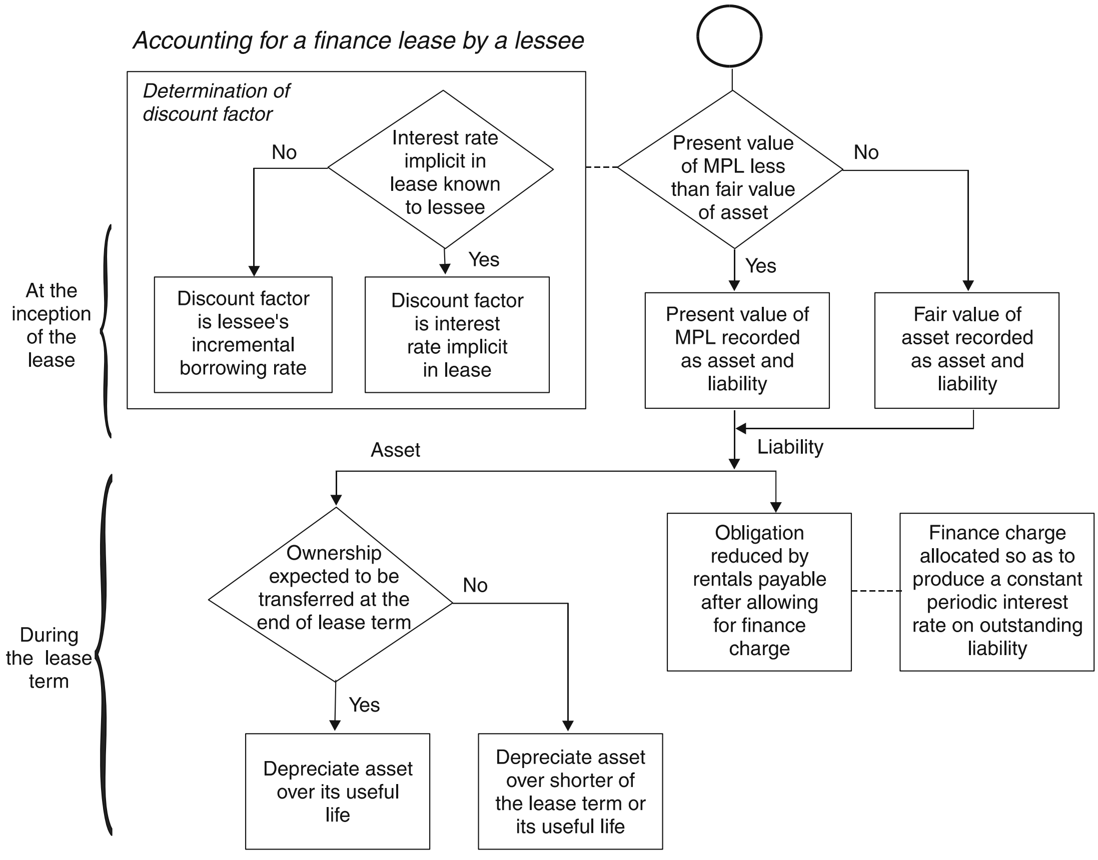
2.3.1 Lessees' disclosures for operating leases

The following should be disclosed. (Remember that these are in addition to requirements under IAS 32: see Chapter 11.)

- The total of **future minimum lease payments** under non-cancellable operating leases for each of the following periods:
  - Not later than one year
  - Later than one year and not later than five years
  - Later than five years
- The total of **future minimum sublease payments** expected to be received under non-cancellable subleases at the year end
- Lease and sublease payments **recognised** as an expense for the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments
- A **general description** of the lessee's significant leasing arrangements including, but not limited to, the following:
  - Basis on which contingent rent payments are determined
  - Existence and terms of renewal or purchase options and escalation clauses
  - Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing

2.4 Section summary

The following diagram gives a useful summary of the **accounting treatment for a finance lease by a lessee.**



MPL = Minimum lease payments

3 Lessor accounting

FAST FORWARD

Lessor accounting:

- **Finance leases:** record the amount due from the lessor in the statement of financial position at the net investment in the lease, recognise finance income to give a constant periodic rate of return.
- **Operating leases:** record as long-term asset and depreciate over useful life, record income on a straight-line basis over the lease term.

To a certain extent at least, the accounting treatment of leases adopted by lessors will be a **mirror image** of that used by lessees.

3.1 Finance leases

Several of the **definitions** given in Section 1 of this chapter are relevant to lessor accounting in particular and you should go back and look at them.

- Unguaranteed residual value
- Gross investment in the lease
- Unearned finance income
- Net investment in the lease

3.2 Accounting treatment

IAS 17 requires the **amount due from the lessee** under a finance lease to be recorded in the statement of financial position of a lessor as a receivable at the amount of the **net investment in the lease**.

The **recognition of finance income** under a finance lease should normally be based on a pattern to give a **constant periodic rate of return** on the lessor's net investment outstanding in respect of the finance lease in each period. In arriving at the constant periodic rate of return, a reasonable approximation may be made.

The lease payments (excluding costs for services) relating to the accounting period should be applied against the gross investment in the lease, so as to **reduce both the principal and the unearned finance income**.

The **estimated unguaranteed residual values** used to calculate the lessor's gross investment in a lease should be reviewed regularly. If there has been a reduction in the value, then the income allocation over the lease term must be revised. Any reduction in respect of amounts already accrued should be recognised immediately.

Initial direct costs incurred by lessors (eg commissions, legal fees and other costs that are directly attributable to negotiating and arranging a lease) are included in the initial measurement of the finance lease receivable.

FAST FORWARD

You should also know how to deal with:

- **Manufacturer/dealer lessors**
- **Sale and leaseback transactions**

3.3 Manufacturer/dealer lessors

IAS 17 looks at the situation where manufacturers or dealers offer customers the choice of either buying or leasing an asset. There will be two types of income under such a lease.

(a) Profit/loss equal to that from an **outright sale** (normal selling price less any discount)
(b) **Finance income** over the lease term

IAS 17 requires the following treatment.

(a) Recognise the **selling profit/loss** in income for the period as if it was an outright sale.

(b) If **interest rates are artificially low**, restrict the selling profit to that which would apply had a commercial rate been applied.

(c) Recognise **costs** incurred in connection with negotiating and arranging a lease as an **expense** when the **selling profit** is recognised (at the start of the lease term).

3.4 Lessors' disclosures for finance leases

The following should be disclosed (in addition to the requirements of IFRS 7).

- A **reconciliation** between the total gross investment in the lease at the year end, and the present value of minimum lease payments receivable at the year end. In addition, an entity should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the year end, for each of the following periods:
  - Not later than one year
  - Later than one year and not later than five years
  - Later than five years
- Unearned finance income
- The unguaranteed residual values accruing to the benefit of the lessor
- The accumulated allowance for uncollectible minimum lease payments receivable
- Contingent rents recognised in income
- A general description of the lessor's material leasing arrangements

3.5 Operating leases

3.5.1 Accounting treatment

An **asset** held for use in operating leases by a lessor should be recorded as a long-term asset and depreciated over its useful life. The basis for depreciation should be consistent with the lessor's policy on similar non-lease assets and follow the guidance in IAS 16.

Income from an operating lease, excluding charges for services such as insurance and maintenance, should be recognised on **a straight-line basis** over the period of the lease (even if the receipts are not on such a basis), unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased asset is receivable.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease should be **added to the carrying amount** of the leased asset and recognised as an expense over the lease term on the same basis as lease income, ie capitalised and amortised over the lease term.

Lessors should refer to IAS 36 in order to determine whether a leased asset has become impaired.

A lessor who is a **manufacturer or dealer** should not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

3.5.2 Lessors' disclosures for operating leases

The following should be disclosed (on top of IAS 32 requirements).

- For each class of asset, the **gross carrying amount**, the accumulated depreciation and accumulated impairment losses at the year end:
  - Depreciation recognised in income for the period
  - Impairment losses recognised in income for the period
  - Impairment losses reversed in income for the period
- The **future minimum lease payments** under non-cancellable operating leases in the aggregate and for each of the following periods:
  - Not later than one year
  - Later than one year and not later than five years
  - Later than five years
- Total **contingent rents** recognised in income
- A **general description** of the lessor's leasing arrangements

3.6 Sale and leaseback transactions

In a sale and leaseback transaction, an asset is sold by a vendor and then the same asset is **leased back** to the same vendor. The lease payment and sale price are normally interdependent because they are negotiated as part of the same package. For example, a company which is short of cash might sell its head office, but at the same time agree to lease the same property back.

The accounting treatment for the lessee or seller should be as follows, depending on the type of lease involved.

(a) In a sale and leaseback transaction which results in a **finance lease**, any apparent profit or loss (that is, the difference between the sale price and the previous carrying value) should be deferred and amortised in the financial statements of the seller/lessee over the lease term. It should not be recognised as income immediately.

(b) If the leaseback is an **operating lease**:

   (i) Any profit or loss should be recognised immediately, provided it is clear that the transaction is established at a **fair value**.

   (ii) Where the **sale price is below fair value**, any profit or loss should be recognised immediately except that if the apparent loss is compensated by future lease payments at

below market price it should to that extent be deferred and amortised over the period for which the asset is expected to be used. The asset created would need to be split between non-current and current elements if the lease spanned more than one accounting period.

(iii) If the **sale price is above fair value**, the excess over fair value should be deferred and amortised over the period over which the asset is expected to be used.

In addition, for an operating lease where the fair value of the asset at the time of the sale is less than the **carrying amount**, the loss (carrying value less fair value) should be recognised immediately.

The buyer or lessor should account for a sale and leaseback in the **same way as other leases**.

The **disclosure requirements** for both lessees and lessors should force disclosure of sale and leaseback transactions. IAS 1 should be considered.

Exam focus point

The December 2013 paper contained a requirement for five marks to explain and show how a lease would be reported in the financial statements. The transaction was a sale and leaseback with an operating lease, with the asset sale at below fair value – resulting in the deferral of the loss on sale and its recognition over the term of the operating lease.

4 Criticism and proposed changes

FAST FORWARD

IAS 17 closed many loopholes, but some still argue that it is **open to manipulation**.

IAS 17 has not been without its critics. The original standard **closed many loopholes** in the treatment of leases, but it has been open to abuse and manipulation. A great deal of this topic is tied up in the off balance sheet finance and creative accounting debate.

Point to note

The material in this section goes beyond what you would be required to know for your exam. It is included here as reading, in order to be prepared for a possible discussion-based question in this area.

4.1 Treatment of operating leases unsatisfactory?

The different accounting treatment of finance and operating leases has been **criticised** for a number of reasons.

(a) Many users of financial statements believe that **all lease contracts give rise to assets and liabilities that should be recognised in the financial statements of lessees**. Therefore, these users routinely adjust the recognised amounts in the statement of financial position in an attempt to assess the effect of the assets and liabilities resulting from operating lease contracts.

(b) The split between finance leases and operating leases can result in **similar transactions being accounted for very differently**, reducing comparability for users of financial statements.

(c) The difference in the accounting treatment of finance leases and operating leases also provides **opportunities to structure transactions so as to achieve a particular lease classification**.

It is also argued that the current accounting treatment of operating leases is **inconsistent with** the definition of assets and liabilities in the **IASB's *Framework***. An operating lease contract confers a valuable right to use a leased item. This right meets the *Framework's* definition of an asset, and the liability of the lessee to pay rentals meets the *Framework's* definition of a liability. However, the right and obligation are not recognised for operating leases.

Lease accounting is **scoped out of IAS 32, IAS 39 and IFRS 9,** which means that there are considerable differences in the treatment of leases and other contractual arrangements.

4.2 IASB Exposure Draft

As mentioned earlier, leasing is the subject of a wider IASB project. Many believe that the current lease accounting is too reliant on bright lines and subjective judgements that may result in economically similar transactions being accounted for differently. The IASB and FASB published a Discussion Paper in March 2009 which focused on lessee accounting and have since decided to address both lessee and lessor accounting. This resulted in an Exposure Draft *Leases*, issued in 2010, which, in effect, **required all leases to be shown on the statement of financial position.** The proposals would result in a consistent approach to lease accounting for both lessees and lessors – a 'right-of-use' approach. Among other changes, this approach would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, thus providing more complete and useful information to investors and other users of financial statements.

Feedback on the 2010 ED was mixed, with many respondents viewing the proposals as **too complex,** particularly with regard to lessor accounting. Feedback indicated that the profit or loss impact of the lessee model did not reflect useful information as a result of so-called 'front-loading' to profit or loss. Front-loading is caused by the combination of a decreasing interest charge over time as the lease liability is repaid and the straight line amortisation of the right-of-use asset. Accordingly, the proposals were simplified and **re-exposed,** taking account of feedback, in **May 2013.**

4.2.1 Basic principle of May 2013 ED – recognition in the statement of financial position

A lessee is **required to recognise a right-of-use asset and a lease liability** for **all leases of more than twelve months.**

For leases of twelve months or less, a lessee is not required to recognise a right-of-use asset and a lease liability, but may choose to do so. This concession was one of the ways in which the 2013 ED addressed concerns about cost and complexity raised in response to the earlier ED.

4.2.2 Scope

The scope of the proposed standard is similar to that of existing lease accounting standards; therefore, most contracts currently accounted for as leases would be subject to the new guidance as well. The ED will not apply to leases of intangible assets, biological assets, exploration rights, and service concessions within the scope of IFRIC 12 *Service concession arrangements*.

In addition, the ED includes conditions for use in determining whether an arrangement contains a lease (currently in IFRIC 4).

4.2.3 Measuring lease assets and liabilities

The **lease liability is measured at the present value of the fixed lease payments** less any lease incentives receivable from the lessor. This includes:

(a) Any variable payments that may be linked to an index or rate
(b) Any amounts payable under residual value guarantees

It excludes variable rents based on performance or usage, which are recognised in profit or loss as incurred. The lease liability is measured in the same way regardless of the nature of the underlying asset.

The **right-of-use asset is measured at cost, based on the amount of the lease liability** plus lease prepayments less any lease incentives received. The right-of-use asset also includes any costs incurred that are directly related to entering into the lease.

4.2.4 Lease term

The lease term is the non-cancellable lease term together with renewal option periods where there is significant economic incentive to extend the lease. The question of significant economic incentive may require judgment.

4.2.5 Dual recognition approach

A single accounting model for lessees would not reflect the true economics of different assets. Accordingly, the IASB developed a dual approach, where the type of lease is based on the amount of consumption of the underlying asset.

Type A leases

Type A leases are leases where the **lessee pays for the part of the asset that it consumes**. They are leases of depreciating assets, for example vehicles or equipment, whose value declines over its useful life, generally faster in the earlier years. Type A leases **normally** mean that the underlying asset is **not property.** However, property will be classified as a Type A lease in either of the following circumstances.

(a) The lease term is for the major part of the remaining economic life of the underlying asset.

(b) The present value of the lease payments accounts for substantially all of the fair value of the underlying asset at the commencement date.

Type B leases

Type B leases are leases for which the lessee **pays for use,** consuming only an insignificant part of the asset. Type B leases **normally** mean the underlying asset is **property**. However, leases other than property leases will be classified as type B leases in either of the following circumstances.

(a) The lease term is for an insignificant part of the total economic life of the underlying asset.

(b) The present value of the lease payments is insignificant relative to the fair value of the underlying asset at the commencement date of the lease.

4.2.6 Recognition of lease expenses and cash outflows

After commencement date, the liability is increased by the unwinding of interest and reduced by lease payments made to the lessor. If there is a change in the expected amount of lease payments, the lease liability is reassessed. The right-of-use asset will be subject to impairment.

The following amounts are recognised in **profit or loss:**

(a) For **type A leases,** the **unwinding of the discount on the lease liability as interest and the amortisation of the right-of-use asset.** The amortisation of the right-of-use asset would be presented in the same line as similar expenses, such as PPE depreciation, and interest on the lease liability in the same line as interest on other, similar, financial liabilities. This would generally result in a **front loading of the expense**.

(b) For **type B leases**, the **lease payments will be recognised in profit or loss on a straight-line basis over the lease term and reflected in profit or loss as a single lease cost.** The single lease cost will be allocated to the actual unwinding of interest on the liability and any remaining lease cost is allocated to the amortisation of the right-of-use asset. These represent amounts paid to provide the lessor with a **return on its investment** in the underlying assets, and the return will probably be **relatively even** over the term of the lease.

4.2.7 Lessor accounting

Lessor accounting for **finance leases** will be **similar to the existing IAS 17** model. For operating leases, a lessor will need to distinguish between property and equipment in a similar way to lessees.

For **operating leases of property** (type B), the accounting is **essentially unchanged.** The leased asset continues to be recognised and rental income is reported in profit or loss.

For **operating leases of vehicles or equipment** (type A), the lessor will need to:

(a) Recognise a lease receivable

(b) Recognise a residual asset being the sum of the present value of any unguaranteed residual, variable lease payments not included in the lease receivable and an allocation of profit relating to the residual asset

(c) Recognise the profit on the portion of the asset leased immediately in profit or loss

(d) Recognise the unwinding of interest on the lease receivable and residual asset in profit or loss over the lease term

4.2.8 Impact

The proposals have met with and will continue to be met with some **opposition**, not least because the old distinction between operating and finance leases would disappear and companies will be required to report larger amounts of assets and liabilities in their statements of financial position. For example, many airlines lease their planes and show no assets or liabilities for their future commitments. Under the ED, an airline entering into a lease for an aircraft would show an asset for the 'right to use' the aircraft and an equal liability based on the current value of the lease payments it has promised to make. Possibly, as a result, loan covenants may be breached and have to be renegotiated.

Although companies may welcome the simplification from the 2010 ED, they are less likely to welcome the new front-loaded approach for vehicles and equipment.

4.3 Unguaranteed residual value

This was defined in Section 1 above. As we have already seen, to qualify as a finance lease the risks and rewards of ownership must be transferred to the lessee. One reward of ownership is any **residual value** in the asset at the end of the primary period. If the asset is returned to the lessor then it is he who receives this reward of ownership, not the lessee. This might prevent the lease from being a finance lease if this reward is significant (IAS 17 allows insubstantial ownership risks and rewards not to pass).

IAS 17 does not state **at what point** it should normally be presumed that a transfer of substantially all the risks and rewards of ownership has occurred. To judge the issue it is necessary to compare the present value of the minimum lease payments against the fair value of the leased assets. This is an application of **discounting principles** to financial statements. The discounting equation is:

Present value of minimum lease payment	+	Present value of unguaranteed residual amount accruing to lessor	=	Fair value of leased asset

Note. Any **guaranteed residual amount** accruing to the lessor will be included in the minimum lease payments.

You should now be able to see the **scope for manipulation** involving lease classification. Whether or not a lease is classified as a finance lease can hinge on the size of the unguaranteed residual amount due to the lessor, and that figure will only be an estimate. A lessor might be persuaded to estimate a larger residual amount than he would otherwise have done and cause the lease to fail the test on present value of lease payments approximating to the asset's fair value, rather than lose the business.

4.4 Example: Unguaranteed residual value

A company enters into two leasing agreements. Let us assume that it has a 90% line to estimate whether the PV of the lease payments are 'substantially' equal to the fair value of the asset.

	Lease A	*Lease B*
	$'000	$'000
Fair value of asset	210	120
Estimated residual value (due to lessor)	21	30
Minimum lease payments	238	108

How should each lease be classified?

Solution

You should note that it is unnecessary to perform any calculations for discounting in this example.

Lease A: it is obvious that the present value of the unguaranteed lease payments is less than $21,000, and therefore less than 10% of the fair value of the asset. This means that the present value of the minimum lease payments is over 90% of the fair value of the asset. Lease A is therefore a finance lease.

Lease B: the present value of the minimum lease payments is obviously less than $108,000 and therefore less than 90% of the fair value of the asset. Lease B is therefore an operating lease.

4.5 Implicit interest rate

It will often be the case that the lessee does not know the unguaranteed residual value placed on the asset by the lessor and he is therefore unaware of the interest rate implicit in the lease. In such a case, IAS 17 allows the lessee to provide his **own estimate**, to calculate the implicit interest rate and perform the test comparing the PV of the lease payments with fair value of the asset. It is obviously very easy to estimate a residual amount which fails the test. This situation would also lead to different results for the lessee and the lessor.

Chapter Roundup

- **IAS 17** covers the accounting under lease transactions for both lessees and lessors.
- There are **two forms of lease**:
  – Finance leases
  – Operating leases
- The definition of a **finance lease** is very important: it is a lease that transfers all the risks and rewards of ownership of the asset, regardless of whether legal title passes.
- Make sure you learn these **important definitions** from IAS 17:
  – Minimum lease payments
  – Interest rate implicit in the lease
  – Guaranteed/unguaranteed residual values
  – Gross net investments in the lease
- **Lessee accounting**:
  – **Finance leases**: record an asset in the statement of financial position and a liability to pay for it (fair value or PV of minimum lease payments), apportion the finance charge to give a constant periodic rate of return.
  – **Operating leases**: write off rentals on a straight line basis.
- **Lessor accounting**:
  – **Finance leases**: record the amount due from the lessor in the statement of financial position at the net investment in the lease, recognise finance income to give a constant periodic rate of return.
  – **Operating leases**: record as long-term asset and depreciate over useful life, record income on a straight-line basis over the lease term.
- You should also know how to deal with:
  – **Manufacturer/dealer lessors**
  – **Sale and leaseback transactions**
- IAS 17 closed many loopholes, but some still argue that it is **open to manipulation**.

Quick Quiz

1 (a) ……………….leases transfer substantially all the risks and rewards of ownership.
  (b) ……………….leases are usually short-term rental agreements with the lessor being responsible for the repairs and maintenance of the asset.

2 A business acquires an asset under a finance lease. What is the double entry?

3 List the disclosures required under IAS 17 for lessees in respect of finance leases.

4 A lorry has an expected useful life of six years. It is acquired under a four year finance lease. Over which period should it be depreciated?

5 A company leases a photocopier under an operating lease which expires in June 20X2. Its office is leased under an operating lease due to expire in January 20X3. How should past and future operating leases be disclosed in its 31 December 20X1 accounts?

Answers to Quick Quiz

1 (a) Finance leases
  (b) Operating leases

2 DEBIT Asset account
  CREDIT Lessor account

3 See Para 2.1.3 and 3.3.1.

4 The four year term, being the shorter of the lease term and the useful life.

5 The total operating lease rentals charged though profit or loss should be disclosed. The payments committed to should be disclosed analysing them between those falling due in the next year and the second to fifth years.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q8	Examination	20	36 mins
Q9	Examination	20	36 mins

7

Intangible assets and goodwill

Topic list	Syllabus reference
1 IAS 38 Intangible assets	B5
2 Research and development costs	B5
3 Goodwill (IFRS 3)	B5

Introduction

We begin our examination of intangible non-current assets with a discussion of the IAS on the subject (**IAS 38**).

Goodwill and its treatment is a controversial area, as is the accounting for items similar to goodwill, such as brands. Goodwill is very important in **group accounts** and we will look at it again in Part D.

Study guide

B5	**Intangible assets and goodwill**
(a)	Discuss the nature and possible accounting treatments of both internally generated and purchased goodwill
(b)	Distinguish between goodwill and other intangible assets
(c)	Define the criteria for the initial recognition and measurement of intangible assets
(e)	Identify the circumstances in which negative goodwill arises, and its subsequent accounting treatment
(f)	Describe and apply the requirements of international accounting standards to internally generated assets other than goodwill (eg research and development)

1 IAS 38 Intangible assets

FAST FORWARD

Intangible assets are defined by IAS 38 as non-monetary assets without physical substance. They must be:

– **Identifiable**
– **Controlled** as a result of a past event
– Able to provide **future economic benefits**

IAS 38 *Intangible assets* was published in 1998 and revised in 2008.

1.1 The objectives of the standard

(a) To establish the criteria for when an intangible asset may or should be **recognised**
(b) To specify how intangible assets should be **measured**
(c) To specify the **disclosure requirements** for intangible assets

1.2 Definition of an intangible asset

The definition of an intangible asset is a key aspect of the standard, because the rules for deciding whether or not an intangible asset may be **recognised** in the accounts of an entity are based on the definition of what an intangible asset is.

Key term

An **intangible asset** is an identifiable non-monetary asset without physical substance The asset must be:

(a) Controlled by the entity as a result of events in the past, and
(b) Something from which the entity expects future economic benefits to flow.

Examples of items that might be considered as intangible assets include computer software, patents, copyrights, motion picture films, customer lists, franchises and fishing rights. An item should not be recognised as an intangible asset, however, unless it **fully meets the definition** in the standard. The guidelines go into great detail on this matter.

1.3 Intangible asset: must be identifiable

An intangible asset must be identifiable in order to distinguish it from goodwill. With non-physical items, there may be a problem with **'identifiability'**. An intangible asset is identifiable in the following circumstances.

(a) If an intangible asset **arises through contractual or other legal rights**, whether or not those rights are separable or can be transferred.

(b) An intangible asset may be identifiable if it is **separable**, ie if it could be rented or sold separately. However, 'separability' is not an essential feature of an intangible asset.

1.4 Intangible asset: control by the entity

Another element of the definition of an intangible asset is that it must be under the control of the entity as a result of a past event. The entity must therefore be able to enjoy the future economic benefits from the asset, and prevent the access of others to those benefits. A **legally enforceable right** is evidence of such control, but is not always a *necessary* condition.

(a) Control over **technical knowledge or know-how** only exists if it is protected by a **legal right**.

(b) The skill of employees, arising out of the benefits of **training costs**, are most unlikely to be recognisable as an intangible asset, because an entity does not control the future actions of its staff.

(c) Similarly, **market share and customer loyalty** cannot normally be intangible assets, since an entity cannot control the actions of its customers.

1.5 Intangible asset: expected future economic benefits

An item can only be recognised as an intangible asset if economic benefits are expected to flow in the future from ownership of the asset. Economic benefits may come from the **sale** of products or services, or from a **reduction in expenditures** (cost savings).

An intangible asset, when recognised initially, must be measured at **cost**. It should be recognised if, and only if **both** the following occur.

(a) It is probable that the **future economic benefits** that are attributable to the asset will **flow to the entity**.

(b) The **cost can be measured reliably**.

Management has to exercise its judgement in assessing the degree of certainty attached to the flow of economic benefits to the entity. External evidence is best.

(a) If an intangible asset is **acquired separately**, its cost can usually be measured reliably as its purchase price (including incidental costs of purchase such as legal fees, and any costs incurred in getting the asset ready for use).

(b) When an intangible asset is acquired as **part of a business combination** (ie an acquisition or takeover), the cost of the intangible asset is its fair value at the date of the acquisition.

IFRS 3 explains that the fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be **recognised separately** from goodwill.

Quoted market prices in an active market provide the most reliable estimate of the fair value of an intangible asset. If no active market exists for an intangible asset, its fair value is the amount that the entity would have paid for the asset, at the acquisition date, in an orderly transaction between market participants, on the basis of the best information available. In determining this amount, an entity should consider the outcome of recent transactions for similar assets. There are techniques for estimating the fair values of unique intangible assets (such as brand names) and these may be used to measure an intangible asset acquired in a business combination.

In accordance with IAS 20, intangible assets acquired by way of government grant and the grant itself may be recorded initially either at cost (which may be zero) or fair value.

1.6 Exchanges of assets

If one intangible asset is exchanged for another, the cost of the intangible asset is measured at fair value unless:

(a) The exchange transaction lacks commercial substance, or

(b) The fair value of neither the asset received nor the asset given up can be measured reliably.

Otherwise, its cost is measured at the carrying amount of the asset given up.

1.7 Internally generated goodwill

Rule to Learn

Internally generated goodwill may **not** be recognised as an **asset**.

The standard deliberately precludes recognition of internally generated goodwill because it requires that, for initial recognition, the cost of the asset rather than its fair value should be capable of being measured reliably and that it should be identifiable and controlled. Thus you do not recognise an asset which is subjective and cannot be measured reliably.

1.8 Disclosure requirements

The standard has fairly extensive disclosure requirements for intangible assets. The financial statements should disclose the **accounting policies** for intangible assets that have been adopted.

For **each class of intangible assets**, disclosure is required of the following.

- The **method of amortisation** used
- The **useful life** of the assets or the amortisation rate used
- The **gross carrying amount**, the **accumulated amortisation** and the **accumulated impairment losses** as at the beginning and the end of the period
- The line in the statement of profit or loss and other comprehensive income in which any amortisation of intangible assets is included
- A **reconciliation of the carrying amount** as at the beginning and at the end of the period (additions, retirements/disposals, revaluations, impairment losses, impairment losses reversed, amortisation charge for the period, net exchange differences, other movements)
- The carrying amount of **internally-generated intangible assets**

The financial statements should also disclose the following.

- In the case of intangible assets that are assessed as having an indefinite useful life, the carrying amounts and the reasons supporting that assessment
- For intangible assets acquired by way of a **government grant** and initially recognised at fair value, the **fair value initially recognised**, the **carrying amount**, and whether they are carried under the **cost model** or the **revaluation model** for subsequent remeasurements
- The carrying amount, nature and remaining amortisation period of any intangible asset that is **material to the financial statements of the entity as a whole**
- The existence (if any) and amounts of intangible assets whose **title is restricted** and of intangible assets that have been **pledged as security** for liabilities
- The amount of any **commitments for the future acquisition of intangible assets**

Where intangible assets are accounted for at revalued amounts, disclosure is required of the following.

- The **effective date of the revaluation** (by class of intangible assets)
- The **carrying amount** of revalued intangible assets
- The carrying amount that would have been shown (by class of assets) **if the cost model had been used**, and the amount of amortisation that would have been charged
- The amount of any **revaluation surplus** on intangible assets, as at the beginning and end of the period, and movements in the surplus during the year (and any restrictions on the distribution of the balance to shareholders)
- The methods and significant assumptions applied in estimating assets' fair values

The financial statements should also disclose the amount of research and development expenditure that have been charged as expenses of the period.

2 Research and development costs

FAST FORWARD

Development costs are recognised as an asset if they meet certain criteria.

2.1 Research

Research activities by definition do not meet the criteria for recognition under IAS 38. This is because, at the research stage of a project, it cannot be certain that future economic benefits will probably flow to the entity from the project. There is too much uncertainty about the likely success or otherwise of the project. **Research costs should therefore be written off as an expense as they are incurred.**

Examples of research costs

(a) Activities aimed at obtaining new knowledge

(b) The search for, evaluation and final selection of, applications of research findings or other knowledge

(c) The search for alternatives for materials, devices, products, processes, systems or services

(d) The formulation, design evaluation and final selection of possible alternatives for new or improved materials, devices, products, systems or services

2.2 Development

Development costs may qualify for recognition as intangible assets provided that the following strict criteria can be demonstrated.

(a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) Its intention to complete the intangible asset and use or sell it.

(c) Its ability to use or sell the intangible asset.

(d) How the intangible asset will generate probable future economic benefits. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) Its ability to measure the expenditure attributable to the intangible asset during its development reliably.

Once these criteria are met, IAS 38 requires development expenditure to be capitalised (ie there is no option of not capitalising it).

In contrast with research costs, development costs are incurred at a later stage in a project, and the probability of success should be more apparent. Examples of development costs include the following.

(a) The design, construction and testing of pre-production or pre-use prototypes and models

(b) The design of tools, jigs, moulds and dies involving new technology

(c) The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production

(d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

2.3 Other internally generated intangible assets

The standard prohibits the recognition of internally generated brands, mastheads, publishing titles and customer lists and similar items as intangible assets. These all fail to meet one or more (in some cases all) the definition and recognition criteria and in some cases are probably indistinguishable from internally generated goodwill.

2.4 Cost of an internally generated intangible asset

FAST FORWARD

Intangible assets should initially be measured at cost, but subsequently they can be carried at **cost** or at a **revalued amount**.

The costs allocated to an internally generated intangible asset should be only costs that can be directly attributed or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use. The principles underlying the costs which may or may not be included are similar to those for other non-current assets and inventory.

The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria. If, as often happens, considerable costs have already been recognised as expenses before management could demonstrate that the criteria have been met, this earlier expenditure should not be retrospectively recognised at a later date as part of the cost of an intangible asset.

Exam focus point

The treatment of development costs is examined frequently. The December 2013 paper, for instance, tested it as part of the consolidation question in the form of an internally generated asset.

Question — Treatment

Doug Co is developing a new production process. During 20X3, expenditure incurred was $100,000, of which $90,000 was incurred before 1 December 20X3 and $10,000 between 1 December 20X3 and 31 December 20X3. Doug Co can demonstrate that, at 1 December 20X3, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process is estimated to be $50,000.

Required

How should the expenditure be treated?

Answer

At the end of 20X3, the production process is recognised as an intangible asset at a cost of $10,000. This is the expenditure incurred since the date when the recognition criteria were met, that is 1 December 20X3. The $90,000 expenditure incurred before 1 December 20X3 is expensed, because the recognition criteria were not met. It will never form part of the cost of the production process recognised in the statement of financial position.

2.5 Recognition of an expense

All expenditure related to an intangible which does not meet the criteria for recognition either as an identifiable intangible asset or as goodwill arising on an acquisition should be **expensed as incurred**. The IAS gives examples of such expenditure:

- Start up costs
- Training costs
- Advertising costs
- Business relocation costs

Prepaid costs for services, for example advertising or marketing costs for campaigns that have been prepared but not launched, can still be recognised as a **prepayment**.

2.6 Measurement of intangible assets subsequent to initial recognition

The standard allows two methods of valuation for intangible assets after they have been first recognised.

Applying the **cost model**, an intangible asset should be **carried at its cost**, less any accumulated amortisation and less any accumulated impairment losses.

The **revaluation model** allows an intangible asset to be carried at a revalued amount, which is its **fair value** at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

(a) The fair value must be able to be measured reliably with reference to an **active market** in that type of asset.

(b) The **entire class** of intangible assets of that type must be revalued at the same time (to prevent selective revaluations).

(c) If an intangible asset in a class of revalued intangible assets cannot be revalued because there is **no active market** for this asset, the asset should be carried at its **cost less any accumulated amortisation and impairment losses**.

(d) Revaluations should be made with such **regularity** that the carrying amount does not differ from that which would be determined using fair value at the end of the reporting period.

Point to note

This treatment is not available for the initial recognition of intangible assets. This is because the cost of the asset must be reliably measured.

The guidelines state that there will not usually be an active market in an intangible asset; therefore the revaluation model will usually not be available. For example, although copyrights, publishing rights and film rights can be sold, each has a unique sale value. In such cases, revaluation to fair value would be inappropriate. A fair value might be obtainable however for assets such as fishing rights or quotas or taxi cab licences.

Where an intangible asset is revalued upwards to a fair value, the amount of the revaluation should be credited directly to equity under the heading of a **revaluation surplus**.

However, if a revaluation surplus is a **reversal of a revaluation decrease** that was previously charged against income, the increase can be recognised as income.

Where the carrying amount of an intangible asset is revalued downwards, the amount of the **downward revaluation** should be charged as an expense against income, unless the asset has previously been revalued upwards. A revaluation decrease should be first charged against any previous revaluation surplus in respect of that asset.

Question — Downward revaluation

An intangible asset is measured by a company at fair value. The asset was revalued by $400 in 20X3, and there is a revaluation surplus of $400 in the statement of financial position. At the end of 20X4, the asset is valued again, and a downward valuation of $500 is required.

Required

State the accounting treatment for the downward revaluation.

Answer

In this example, the downward valuation of $500 can first be set against the revaluation surplus of $400. The revaluation surplus will be reduced to $nil and a charge of $100 made as an expense in 20X4.

When the revaluation model is used, and an intangible asset is revalued upwards, the cumulative revaluation **surplus may be transferred to retained earnings** when the surplus is eventually realised. The

surplus would be realised when the asset is disposed of. However, the surplus may also be realised over time as the **asset is used** by the entity. The amount of the surplus realised each year is the difference between the amortisation charge for the asset based on the revalued amount of the asset, and the amortisation that would be charged on the basis of the asset's historical cost. The realised surplus in such case should be transferred from revaluation surplus directly to retained earnings, and should not be taken through profit or loss.

2.7 Useful life

An entity should assess the useful life of an intangible asset, which may be **finite or indefinite**. An intangible asset has an indefinite useful life when there is **no foreseeable limit** to the period over which the asset is expected to generate net cash inflows for the entity.

Many factors are considered in determining the useful life of an intangible asset, including:

- Expected usage
- Typical product life cycles
- Technical, technological, commercial or other types of obsolescence
- The stability of the industry; expected actions by competitors
- The level of maintenance expenditure required
- Legal or similar limits on the use of the asset, such as the expiry dates of related leases

Computer software and many other intangible assets normally have short lives because they are susceptible to technological obsolescence. However, uncertainty does not justify choosing a life that is unrealistically short.

The useful life of an intangible asset that arises from **contractual or other legal rights** should not exceed the period of the rights, but may be shorter depending on the period over which the entity expects to use the asset.

2.8 Amortisation period and amortisation method

An intangible asset with a finite useful life should be amortised over its **expected useful life**.

(a) Amortisation should start when the asset is **available for use**.

(b) Amortisation should cease at the earlier of the date that the asset is classified **as held for sale** in accordance with IFRS 5 *Non-current assets held for sale and discontinued operations* and the date that the asset is **derecognised**.

(c) The amortisation method used should reflect the **pattern in which the asset's future economic benefits are consumed**. If such a pattern cannot be predicted reliably, the straight-line method should be used.

(d) The amortisation charge for each period should normally be recognised **in profit or loss**.

The **residual value** of an intangible asset with a finite useful life is **assumed to be zero** unless a third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset (so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.

The amortisation period and the amortisation method used for an intangible asset with a finite useful life should be **reviewed at each financial year-end**.

2.9 Intangible assets with indefinite useful lives

An intangible asset with an indefinite useful life **should not be amortised**. (IAS 36 requires that such an asset is tested for impairment at least annually.)

The useful life of an intangible asset that is not being amortised should be **reviewed each year** to determine whether it is still appropriate to assess its useful life as indefinite. Reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired and therefore it should be tested for impairment.

Question — Intangible asset

It may be difficult to establish the useful life of an intangible asset, and judgement will be needed.

Required

Consider how to determine the useful life of a *purchased* brand name.

Answer

Factors to consider would include the following.

(a) Legal protection of the brand name and the control of the entity over the (illegal) use by others of the brand name (ie control over pirating)

(b) Age of the brand name

(c) Status or position of the brand in its particular market

(d) Ability of the management of the entity to manage the brand name and to measure activities that support the brand name (eg advertising and PR activities)

(e) Stability and geographical spread of the market in which the branded products are sold

(f) Pattern of benefits that the brand name is expected to generate over time

(g) Intention of the entity to use and promote the brand name over time (as evidenced perhaps by a business plan in which there will be substantial expenditure to promote the brand name)

2.10 Disposals/retirements of intangible assets

An intangible asset should be eliminated from the statement of financial position when it is disposed of or when there is no further expected economic benefit from its future use. On disposal the gain or loss arising from the **difference between the net disposal proceeds and the carrying amount** of the asset should be taken to profit or loss as a gain or loss on disposal (ie treated as income or expense).

2.11 Section summary

- An intangible asset should be recognised if, and only if, it is probable that future economic benefits will flow to the entity and the cost of the asset can be measured reliably.
- An asset is initially recognised at cost and subsequently carried either at cost or revalued amount.
- Costs that do not meet the recognition criteria should be expensed as incurred.
- An intangible asset with a finite useful life should be amortised over its useful life. An intangible asset with an indefinite useful life should not be amortised.

Question — R&D

As an aid to your revision, list the examples given in IAS 38 of activities that might be included in either research or development.

Answer

IAS 38 gives these examples.

Research

- Activities aimed at obtaining new knowledge
- The search for applications of research findings or other knowledge
- The search for product or process alternatives
- The formulation and design of possible new or improved product or process alternatives

Development

- The evaluation of product or process alternatives
- The design, construction and testing of pre-production prototypes and models
- The design of tools, jigs, moulds and dies involving new technology
- The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production

3 Goodwill (IFRS 3)

FAST FORWARD

Purchased goodwill arising on consolidation is retained in the statement of financial position as an intangible asset under IFRS 3. It must then be reviewed annually for impairment.

3.1 What is goodwill?

Goodwill may be **created by good relationships** between a business and its customers. This may be done:

(a) By building up a **reputation** (by word of mouth perhaps) for high quality products or high standards of service

(b) By **responding promptly and helpfully** to queries and complaints from customers

(c) Through the **personality of the staff** and their attitudes to customers

The value of goodwill to a business might be considerable. However, goodwill is not usually valued in the accounts of a business at all, and we should not normally expect to find an amount for goodwill in its statement of financial position. For example, the welcoming smile of the bar staff may contribute more to a bar's profits than the fact that a new electronic cash register has recently been acquired. Even so, whereas the cash register will be recorded in the accounts as a non-current asset, the value of staff would be ignored for accounting purposes.

On reflection, we might agree with this omission of goodwill from the accounts of a business.

(a) The goodwill is **inherent** in the business but it has not been paid for, and it does not have an 'objective' value. We can guess at what such goodwill is worth, but such guesswork would be a matter of individual opinion, and not based on hard facts.

(b) Goodwill **changes** from day to day. One act of bad customer relations might damage goodwill and one act of good relations might improve it. Staff with a favourable personality might retire or leave to find another job, to be replaced by staff who need time to find their feet in the job, etc. Since goodwill is continually changing in value, it cannot realistically be recorded in the accounts of the business.

3.2 Purchased goodwill

There is one exception to the general rule that goodwill has no objective valuation. This is **when a business is sold**. People wishing to set up in business have a choice of how to do it – they can either buy their own long-term assets and inventory and set up their business from scratch, or they can buy up an existing business from a proprietor willing to sell it. When a buyer purchases an existing business, he will have to purchase not only its long-term assets and inventory (and perhaps take over its accounts payable and receivable too) but also the goodwill of the business.

FAST FORWARD

Purchased goodwill is shown in the statement of financial position because it has been paid for. It has no tangible substance, and so it is an **intangible non-current asset**.

3.3 How is the value of purchased goodwill decided?

When a business is sold, there is likely to be some purchased goodwill in the selling price. But **how is the amount of this purchased goodwill decided**?

This is not really a problem for accountants, who must simply record the goodwill in the accounts of the new business. The value of the goodwill is a **matter for the purchaser and seller to agree upon in fixing the purchase/sale price**. However, two methods of valuation are worth mentioning here.

(a) The seller and buyer agree on a price for the business **without specifically quantifying the goodwill**. The purchased goodwill will then be the difference between the price agreed and the value of the identifiable net assets in the books of the new business.

(b) However, the calculation of goodwill often precedes the fixing of the purchase price and becomes a **central element of negotiation**. There are many ways of arriving at a value for goodwill and most of them are related to the profit record of the business in question.

No matter how goodwill is calculated within the total agreed purchase price, the goodwill shown by the purchaser in his accounts will be **the difference between the purchase consideration and his own valuation of the net assets acquired**. If A values his net assets at $40,000, goodwill is agreed at $21,000 and B agrees to pay $61,000 for the business but values the net assets at only $38,000, then the goodwill in B's books will be $61,000 – $38,000 = $23,000.

3.4 IFRS 3 Business combinations

FAST FORWARD

If a business has **goodwill**, it means that the value of the business as a going concern is greater than value of its separate tangible assets. The valuation of goodwill is extremely subjective and fluctuates constantly. For this reason, non-purchased goodwill is **not** shown as an asset in the statement of financial position.

IFRS 3 covers the accounting treatment of goodwill acquired in a business combination.

Key terms

Goodwill. Future economic benefits arising from assets that are not capable of being individually identified and separately recognised. *(IFRS 3)*

Goodwill acquired in a business combination is **recognised as an asset** and is initially measured at **cost**. Cost is the excess of the cost of the combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

After initial recognition goodwill acquired in a business combination is measured **at cost less any accumulated impairment losses**. It is **not amortised**. Instead it is tested for impairment at least annually, in accordance with IAS 36 *Impairment of assets*.

3.4.1 Bargain purchase

A **bargain purchase** arises when the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed exceeds the consideration transferred (see Chapter 12).

A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items may also result in recognising a gain (or change the amount of a recognised gain) on a bargain purchase.

Before recognising a gain on a bargain purchase, the acquirer must reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and must recognise any additional assets or liabilities that are identified in that review. The acquirer must then review the procedures used to measure the amounts this IFRS requires to be recognised at the acquisition date for all of the following:

(a) The identifiable assets acquired and liabilities assumed

(b) The non-controlling (formerly minority) interest in the acquiree, if any

(c) For a business combination achieved in stages, the acquirer's previously held interest in the acquiree

(d) The consideration transferred

The purpose of this review is to ensure that the measurements appropriately reflect all the available information as at the acquisition date.

Exam focus point

> Goodwill recognition and impairment is a key aspect of group accounts preparation. You should expect it to be examined very frequently.
>
> The December 2012 paper included the impairment of goodwill within the consolidation question (question one). It was necessary first to calculated the carrying amount of goodwill in the usual way, and then to compare this with the recoverable amount given in the question to get the impairment loss.

Question

Characteristics of goodwill

What are the main characteristics of goodwill which distinguish it from other intangible non-current assets? To what extent do you consider that these characteristics should affect the accounting treatment of goodwill? State your reasons.

Answer

Goodwill may be distinguished from other intangible non-current assets by reference to the following characteristics.

(a) It is incapable of realisation separately from the business as a whole.

(b) Its value has no reliable or predictable relationship to any costs which may have been incurred.

(c) Its value arises from various intangible factors such as skilled employees, effective advertising or a strategic location. These indirect factors cannot be valued.

(d) The value of goodwill may fluctuate widely according to internal and external circumstances over relatively short periods of time.

(e) The assessment of the value of goodwill is highly subjective.

It could be argued that, because goodwill is so different from other intangible non-current assets it does not make sense to account for it in the same way. Thus the capitalisation and amortisation treatment would not be acceptable. Furthermore, because goodwill is so difficult to value, any valuation may be misleading, and it is best eliminated from the statement of financial position altogether. However, there are strong arguments for treating it like any other intangible non-current asset. This issue remains controversial.

Chapter Roundup

- Intangible assets are defined by IAS 38 as non-monetary assets without physical substance. They must be:
  - **Identifiable**
  - **Controlled** as a result of a past event
  - Able to provide **future economic benefits**
- Development costs are recognised as an asset if they meet certain criteria.
- Intangible assets should initially be measured at cost, but subsequently they can be carried at **cost** or at a **revalued amount**.
- Purchased goodwill arising on consolidation is retained in the statement of financial position as an intangible asset under IFRS 3. It must then be reviewed annually for impairment.
- Purchased goodwill is shown in the statement of financial position because it has been paid for. It has no tangible substance and so it is an **intangible non-current asset**.
- If a business has **goodwill**, it means that the value of the business as a going concern is greater than value of its separate tangible assets. The valuation of goodwill is extremely subjective and fluctuates constantly. For this reason, non-purchased goodwill is **not** shown as an asset in the statement of financial position.

Quick Quiz

1 Intangible assets can only be recognised in a company's accounts if:
- It is probable that ……………………… will flow to the entity
- The cost can be ………………………..

2 What are the criteria which must be met before development expenditure can be deferred?

3 Start up costs must be expensed.

True ☐

False ☐

4 Peggy buys Phil's business for $30,000. The business assets are a bar valued at $20,000, inventories at $3,000 and receivables of $3,000. How much is goodwill valued at?

5 What method of accounting for goodwill arising on consolidation is required by IFRS 3?

6 What treatment does IFRS 3 prescribe for a gain on a bargain purchase?

Answers to Quick Quiz

1 Future economic benefits. Measured reliably.
2 See Para 2.2
3 True
4 \$30,000 – \$20,000 – \$3,000 – \$3,000 = \$4,000
5 Cost less impairment losses
6 Before recognising a gain, measurement procedures for assets and liabilities and for consideration must be reviewed.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q10	Examination	20	36 mins

8

Inventories and construction contracts

Topic list	Syllabus reference
1 Inventories and short-term WIP (IAS 2)	B6
2 IAS 11 Construction contracts	B6

Introduction

You have encountered inventory and its valuation in your earlier studies. Inventory and short-term work-in-progress valuation has a direct impact on a company's gross profit and it is usually a material item in any company's accounts. This is therefore an important subject area. If you have any doubts about accounting for inventories and methods of inventory valuation you would be advised to go back to your earlier study material and revise this topic.

Section 1 of this chapter goes over some of this ground again, concentrating on the effect of IAS 2. Section 2 goes on to discuss a new area, construction contracts, which are effectively long-term work in progress. You should find this topic fairly logical as long as you work through the examples and question carefully.

Study guide

B6	**Inventories and construction contracts**
(a)	Measure and value inventories
(b)	Define a construction contract and describe why recognising profit before completion is generally considered to be desirable; discuss if this may be profit smoothing (IAS 11)
(c)	Describe the ways in which contract revenue and contract cost may be recognised
(d)	Calculate and disclose the amounts to be shown in the financial statements for construction contracts

1 Inventories and short-term WIP (IAS 2)

FAST FORWARD

IAS 2 *Inventories* requires that the statement of financial position should show **inventories** classified in a manner appropriate to the entity. Common **classifications** are:

– Merchandise
– Production supplies
– Materials
– Work in progress
– Finished goods

1.1 Introduction

In most businesses the value put on inventory is an important factor in the determination of profit. Inventory valuation is, however, a highly subjective exercise and consequently there is a wide variety of different methods used in practice.

1.2 IAS 2 Inventories

IAS 2 lays out the required accounting treatment for inventories (sometimes called stocks) under the historical cost system. The major area of contention is the cost **value of inventory** to be recorded. This is recognised as an asset of the entity until the related revenues are recognised (ie the item is sold) at which point the inventory is recognised as an expense (ie cost of sales). Part or all of the cost of inventories may also be expensed if a write-down to **net realisable value** is necessary. The revised IAS also provides guidance on the cost formulas that are used to assign costs to inventories.

In other words, the fundamental accounting assumption of **accruals** requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods which remain unsold at the year end must be carried forward in the statement of financial position and matched against future revenues.

1.3 Scope

The following items are **excluded** from the scope of the standard.

- Work in progress under **construction contracts** (covered by IAS 11 *Construction contracts,* see Section 2)
- **Financial instruments** (ie shares, bonds)
- **Biological assets**

Certain inventories are exempt from the standard's **measurement rules**, ie those held by:

- Producers of **agricultural and forest products**
- **Commodity-broker traders**

1.4 Definitions

The following definitions are important.

Key terms

- **Inventories** are assets:
  - held for sale in the ordinary course of business;
  - in the process of production for such sale; or
  - in the form of materials or supplies to be consumed in the production process or in the rendering of services.
- **Net realisable value** is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. (IAS 2)
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13)

Inventories can **include** any of the following.

- **Goods purchased and held for resale**, eg goods held for sale by a retailer, or land and buildings held for resale
- **Finished goods** produced
- **Work in progress** being produced
- Materials and supplies awaiting use in the production process (**raw materials**)

1.5 Measurement of inventories

The standard states that '**Inventories should be measured at the lower of cost and net realisable value**.'

Exam focus point

This is a very important rule and you will be expected to apply it in the exam.

1.6 Cost of inventories

The cost of inventories will consist of all costs of:

- **Purchase**
- **Costs of conversion**
- **Other costs** incurred in bringing the inventories to their **present location and condition**

1.6.1 Costs of purchase

The standard lists the following as comprising the costs of purchase of inventories:

- **Purchase price** *plus*
- **Import duties** and other taxes *plus*
- Transport, handling and any other cost **directly attributable** to the acquisition of finished goods, services and materials *less*
- **Trade discounts**, rebates and other similar amounts

1.6.2 Costs of conversion

Costs of conversion of inventories consist of two main parts.

(a) Costs **directly related** to the units of production, eg direct materials, direct labour

(b) Fixed and variable **production overheads** that are incurred in converting materials into finished goods, allocated on a systematic basis.

You may have come across the terms 'fixed production overheads' or 'variable production overheads' elsewhere in your studies. The standard defines them as follows.

Key terms

- **Fixed production overheads** are those indirect costs of production that remain relatively constant regardless of the volume of production, eg the cost of factory management and administration.
- **Variable production overheads** are those indirect costs of production that vary directly, or nearly directly, with the volume of production, eg indirect materials and labour. *(IAS 2)*

The standard emphasises that fixed production overheads must be allocated to items of inventory on the basis of the **normal capacity of the production facilities**. This is an important point.

(a) **Normal capacity** is the expected achievable production based on the average over several periods/seasons, under normal circumstances.
(b) The above figure should take account of the capacity lost through **planned maintenance**.
(c) If it approximates to the normal level of activity then the **actual level of production** can be used.
(d) **Low production** or **idle plant** will *not* result in a higher fixed overhead allocation to each unit.
(e) **Unallocated overheads** must be recognised as an expense in the period in which they were incurred.
(f) When production is **abnormally high**, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.
(g) The allocation of variable production overheads to each unit is based on the **actual use** of production facilities.

1.6.3 Other costs

Any other costs should only be recognised if they are incurred in bringing the inventories to their **present location and condition**.

The standard lists types of cost which **would not be included** in cost of inventories. Instead, they should be recognised as an **expense** in the period they are incurred.

(a) **Abnormal amounts** of wasted materials, labour or other production costs
(b) **Storage costs** (except costs which are necessary in the production process before a further production stage)
(c) **Administrative overheads** not incurred to bring inventories to their present location and conditions
(d) **Selling costs**

1.6.4 Techniques for the measurement of cost

Two techniques are mentioned by the standard, both of which produce results which **approximate to cost**, and so both of which may be used for convenience.

(a) **Standard costs** are set up to take account of normal production values: amount of raw materials used, labour time etc. They are reviewed and revised on a regular basis.
(b) **Retail method**: this is often used in the retail industry where there is a large turnover of inventory items, which nevertheless have similar profit margins. The only practical method of inventory valuation may be to take the total selling price of inventories and deduct an overall average profit margin, thus reducing the value to an approximation of cost. The percentage will take account of reduced price lines. Sometimes different percentages are applied on a department basis.

1.7 Cost formulae

Cost of inventories should be assigned by **specific identification** of their individual costs for:

(a) Items that are **not ordinarily interchangeable**
(b) Goods or services produced and segregated for **specific projects**

Specific costs should be attributed to individual items of inventory when they are segregated for a specific project, but not where inventories consist of a large number of interchangeable (ie identical or very similar) items. In the latter case the rule is as specified below.

1.7.1 Interchangeable items

Rule to learn

The cost of inventories should be assigned by using the **first-in, first-out (FIFO)** or **weighted average** cost formulas. The LIFO formula (last in, first out) is **not permitted** by the revised IAS 2.

You should be familiar with these methods from your earlier studies. Under the weighted average cost method, a recalculation can be made after each purchase, **or alternatively only at the period end**.

1.8 Net realisable value (NRV)

FAST FORWARD

Full details are required of inventory carried at **NRV** as well as the reversal of any previous write down.

As a general rule assets should not be carried at amounts greater than those expected to be realised from their sale or use. In the case of inventories this amount could fall below cost when items are **damaged or become obsolete**, or where the **costs to completion have increased** in order to make the sale.

In fact we can identify the principal situations in which **NRV is likely to be less than cost**, ie where there has been:

(a) An **increase in costs** or a **fall in selling price**
(b) A **physical deterioration** in the condition of inventory
(c) **Obsolescence** of products
(d) A decision as part of the company's marketing strategy to manufacture and sell products at a **loss**
(e) **Errors in production or purchasing**

A write down of inventories would normally take place on an item by item basis, but similar or related items may be **grouped together**. This grouping together is acceptable for, say, items in the same product line, but it is not acceptable to write down inventories based on a whole classification (eg finished goods) or a whole business.

The assessment of NRV should take place **at the same time** as estimates are made of selling price, using the most reliable information available. Fluctuations of price or cost should be taken into account if they relate directly to **events after the reporting period,** which confirm conditions existing at the end of the period.

The reasons why inventory is held must also be taken into account. Some inventory, for example, may be held to satisfy a firm contract and its NRV will therefore be the **contract price**. Any additional inventory of the same type held at the period end will, in contrast, be assessed according to general sales prices when NRV is estimated.

Net realisable value must be reassessed at the end of each period and compared again with cost. If the NRV has risen for inventories held over the end of more than one period, then the previous write down must be **reversed** to the extent that the inventory is then valued at the lower of cost and the new NRV. This may be possible when selling prices have fallen in the past and then risen again.

On occasion a write down to NRV may be of such size, incidence or nature that it must be **disclosed separately**.

1.9 Recognition as an expense

The following treatment is required **when inventories are sold**.

(a) The **carrying amount** is recognised as an expense in the period in which the related revenue is recognised
(b) The amount of any **write-down of inventories** to NRV and all losses of inventories are recognised as an expense in the period the write-down or loss occurs

(c) The amount of any **reversal of any write-down of inventories**, arising from an increase in NRV, is recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs

Question — Inventory valuation

A company has inventory on hand at the end of the reporting period as follows:

	Units	*Raw material cost*	*Attributable production overheads*	*Attributable selling costs*	*Expected selling*
		$	*$*	*$*	*$*
Item A	300	160	15	12	185
Item B	250	50	10	10	75

At what amount will inventories be stated in the statement of financial position in accordance with IAS 2?

Answer

	Units	*Cost*	*NRV*	*Lower*	*Total*
		$	*$*	*$*	*$*
Item A	300	175	173	173	51,900
Item B	250	60	65	60	15,000
					66,900

1.10 Consistency – different cost formulae for inventories

FAST FORWARD

The use of **LIFO** is **prohibited** under IAS 2.

IAS 2 allows two cost formulas (FIFO or weighted average cost) for inventories that are ordinarily interchangeable or are not produced and segregated for specific projects. The issue is whether an entity may use different cost formulas for different types of inventories.

IAS 2 provides that an entity should use **the same cost formula for all inventories having similar nature and use to the entity.** For inventories with different nature or use (for example, certain commodities used in one business segment and the same type of commodities used in another business segment), different cost formulas may be justified. A difference in geographical location of inventories (and in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

2 IAS 11 Construction contracts

FAST FORWARD

Sales revenue on a construction contract is based upon stage of completion.

2.1 Introduction

Imagine that you are the accountant at a construction company. Your company is building a large tower block that will house offices, under a contract with an investment company. It will take three years to build the block and over that time you will obviously have to pay for building materials, wages of workers on the building, architects' fees and so on. You will receive periodic payments from the investment company at various predetermined stages of the construction. How do you decide, in each of the three years, **what to include as income and expenditure** for the contract in the statement of profit or loss?

This is the problem tackled by IAS 11 *Construction contracts*.

2.2 Example: construction contract

A numerical example might help to illustrate the problem. Suppose that a contract is started on 1 January 20X5, with an estimated completion date of 31 December 20X6. The final contract price is $1,500,000. In the first year, to 31 December 20X5:

(a) Costs incurred amounted to $600,000.

(b) Half the work on the contract was completed.

(c) Certificates of work completed have been issued, to the value of $750,000. (*Note*. It is usual, in a construction contract, for a qualified person such as an architect or engineer to inspect the work completed, and if it is satisfactory, to issue certificates. This will then be the notification to the customer that progress payments are now due to the contractor. Progress payments are commonly the amount of valuation on the work certificates issued, minus a precautionary retention of 10%).

(d) It is estimated with reasonable certainty that further costs to completion in 20X6 will be $600,000.

What is the contract profit in 20X5, and what entries would be made for the contract at 31 December 20X5 if:

(a) Profits are deferred until the completion of the contract?

(b) A proportion of the estimated revenue and profit is credited to profit or loss in 20X5?

Solution

(a) If profits were deferred until the completion of the contract in 20X6, the revenue and profit recognised on the contract in 20X5 would be nil, and the value of work in progress on 31 December 20X5 would be $600,000. IAS 11 takes the view that this policy is unreasonable, because in 20X6, the total profit of $300,000 would be recorded. Since the contract revenues are earned throughout 20X5 and 20X6, a profit of nil in 20X5 and $300,000 in 20X6 would be contrary to the accruals concept of accounting.

(b) **It is fairer to recognise revenue and profit throughout the duration of the contract.**

As at 31 December 20X5 revenue of $750,000 should be matched with cost of sales of $600,000 in the statement of profit or loss, leaving an attributable profit for 20X5 of $150,000.

The only entry in the statement of financial position as at 31 December 20X5 is a receivable of $750,000 recognising that the company is owed this amount for work done to date. No balance remains for work in progress, the whole $600,000 having been recognised in cost of sales.

2.3 What is a construction contract?

A contract which needs IAS 11 treatment does not have to last for a period of more than one year. The main point is that the contract activity **starts in one financial period and ends in another**, thus creating the problem: to which of two or more periods should contract income and costs be allocated? In fact the definition given in the IAS of a construction contract is very straightforward.

Key term

Construction contract. A contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. *(IAS 11)*

The standard differentiates between fixed price contracts and cost plus contracts.

Key terms

- **Fixed price contract.** A contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.
- **Cost plus contract.** A construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

Construction contracts may involve the building of one asset, eg a bridge, or a series of interrelated assets eg an oil refinery. They may also include **rendering of services** (eg architects) or restoring or demolishing an asset.

2.4 Combining and segmenting construction contracts

The standard lays out the factors which determine whether the construction of a **series of assets** under one contract should be treated as several contracts.

- **Separate proposals** are submitted for each asset
- **Separate negotiations** are undertaken for each asset; the customer can accept/reject each individually
- **Identifiable costs and revenues** can be separated for each asset

There are also circumstances where a **group of** contracts should be treated as **one single construction contract**.

- The group of contracts are negotiated as a **single package**
- Contracts are **closely interrelated**, with an overall profit margin
- The contracts are performed **concurrently** or **in a single sequence**

2.5 Contract revenue

Contract revenue will be the **amount specified in the contract**, subject to variations in the contract work, incentive payments and claims *if* these will probably give rise to revenue and *if* they can be reliably measured. The result is that contract revenue is measured at the **fair value** of received or receivable revenue.

The standard elaborates on the types of uncertainty, which depend on the outcome of future events, that affect the **measurement of contract revenue**.

- An **agreed variation** (increase/decrease)
- **Cost escalation clauses** in a fixed price contract (increase)
- **Penalties** imposed due to delays by the contractor (decrease)
- **Number of units** varies in a contract for fixed prices per unit (increase/decrease)

In the case of any variation, claim or incentive payment, two factors should be assessed to determine whether contract revenue should be recognised.

- Whether it is **probable** that the customer will accept the variation/claim, or that the contract is sufficiently advanced that the performance criteria will be met
- Whether the amount of the revenue can be **measured reliably**

2.6 Contract costs

Contract costs consist of:

- Costs relating **directly** to the contract
- Costs attributable to general contract activity which can be **allocated** to the contract, such as insurance, cost of design and technical assistance not directly related to a specific contract and construction overheads
- Any other costs which can be **charged to the customer** under the contract, which may include general administration costs and development costs

Costs that **relate directly** to a specific contract include the following.

- **Site labour costs**, including site supervision
- Costs of **materials** used in construction
- **Depreciation** of plant and equipment used on the contract
- Costs of **moving** plant, equipment and materials to and from the contract site
- Costs of **hiring** plant and equipment
- Costs of **design and technical assistance** that are directly related to the contract
- Estimated costs of **rectification and guarantee work**, including expected warranty costs
- **Claims from third parties**

General contract activity costs should be **allocated systematically and rationally**, and all costs with similar characteristics should be treated **consistently**. The allocation should be based on the **normal level** of construction activity. Borrowing costs may be attributed in this way (see IAS 23: Chapter 4).

Some costs **cannot be attributed** to contract activity and so the following should be **excluded** from construction contract costs.

- **General administration costs** (unless reimbursement is specified in the contract)
- **Selling costs**
- **R&D** (unless reimbursement is specified in the contract)
- **Depreciation** of idle plant and equipment not used on any particular contract

2.7 Recognition of contract revenue and expenses

Revenue and costs associated with a contract should be recognised according to the stage of completion of the contract at the end of the reporting period, but *only when* the **outcome of the activity can be estimated reliably**. If a loss is predicted on a contract, then it should be recognised immediately. This is often known as the **percentage of completion method**.

A reliable estimate of the outcome of a construction contract can only be made when **certain conditions** have been met, and these conditions will be different for fixed price and cost plus contracts.

- **Fixed price contracts**
  - Probable that economic benefits of the contract will flow to the entity
  - Total contract revenue can be reliably measured
  - Stage of completion at the period end and costs to complete the contract can be reliably measured
  - Costs attributable to the contract can be identified clearly and be reliably measured (actual costs can be compared to previous estimates)
- **Cost plus contracts**
  - Probable that economic benefits of the contract will flow to the entity
  - Costs attributable to the contract (whether or not reimbursable) can be identified clearly and be reliably measured

The **percentage of completion method** is an application of the accruals assumption. Contract revenue is matched to the contract costs incurred in reaching the stage of completion, so revenue, costs and profit are attributed to the proportion of work completed.

We can **summarise** the treatment as follows.

- Recognise **contract revenue** as revenue in the accounting periods in which the work is performed
- Recognise **contract costs** as an expense in the accounting period in which the work to which they relate is performed
- Any **expected excess** of total contract costs over total contract revenue should be recognised as an expense immediately
- Any costs incurred which relate to **future activity** should be recognised as an asset if it is probable that they will be recovered (often called contract work in progress, ie amounts due from the customer)
- Where amounts have been recognised as contract revenue, but their **collectability** from the customer becomes doubtful, such amounts should be recognised as an expense, not a deduction from revenue

2.8 When can reliable estimates be made?

IAS 11 only allows contract revenue and costs to be recognised when the outcome of the contract can be predicted, ie when it is probable that the economic benefits attached to the contract will flow to the entity. IAS 11 states that this can only be when a contract has been agreed which establishes the following.

- The **enforceable rights** of each party in respect of the asset to be constructed
- The **consideration** that is to be exchanged
- **Terms and manner of settlement**

In addition, the entity should have an **effective internal financial budgeting and reporting system**, in order to review and revise the estimates of contract revenue and costs as the contract progresses.

2.9 Determining the stage of completion

How should you decide on the stage of completion of any contract? The standard lists several methods.

- **Proportion of contract costs incurred** for work carried out to date
- **Surveys** of work carried out
- **Physical proportion** of the contract work completed

2.10 Example: stage of completion

Centrepoint Co have a fixed price contract to build a tower block. The initial amount of revenue agreed is \$220m. At the beginning of the contract on 1 January 20X6 the initial estimate of the contract costs is \$200m. At the end of 20X6 the estimate of the total costs has risen to \$202m.

During 20X7 the customer agrees to a variation which increases expected revenue from the contract by \$5m and causes additional costs of \$3m. At the end of 20X7 there are materials stored on site for use during the following period which cost \$2.5m.

Centrepoint Co have decided to determine the stage of completion of the contract by calculating the proportion that contract costs incurred for work to date bear to the latest estimated total contract costs. The contract costs incurred at the end of each year were 20X6: \$52.52m, 20X7: \$154.2m (including materials in store), 20X8: \$205m.

Required

Calculate the stage of completion for each year of the contract and show how revenues, costs and profits will be recognised in each year.

Solution

We can summarise the financial data for each year end during the construction period as follows.

	20X6	*20X7*	*20X8*
	\$'000	\$'000	\$'000
Initial amount of revenue agreed in the contract	220,000	220,000	220,000
Variation	–	5,000	5,000
Total contract revenue	220,000	225,000	225,000
Contract costs incurred to date	52,520	154,200	205,000
Contract costs to complete	149,480	50,800	–
Total estimated contract costs	202,000	205,000	205,000
Estimated profit	18,000	20,000	20,000
Stage of completion	26%	74%	100%

The stage of completion has been calculated using the formula:

$$\frac{\text{Contract costs incurred to date}}{\text{Total estimated contract costs}}$$

The stage of completion in 20X7 is calculated by deducting the \$2.5m of materials held for the following period from the costs incurred up to that year end, ie \$154.2m – \$2.5m = \$151.7m. \$151.7m/\$205m = 74%.

Revenue, expenses and profit will be recognised in profit or loss as follows.

		To date	*Recognised in prior years*	*Recognised in current year*
		$'000	$'000	$'000
20X6	Revenue ($220m × 26%)	57,200		
	Costs ($202m × 26%)	52,520		
		4,680		
20X7	Revenue ($225m × 74%)	166,500	57,200	109,300
	Costs ($205m × 74%)	151,700	52,520	99,180
		14,800	4,680	10,120
20X8	Revenue ($225m × 100%)	225,000	166,500	58,500
	Costs ($205m × 100%)	205,000	151,700	53,300
		20,000	14,800	5,200

You can see from the above example that, when the stage of completion is determined using the contract costs incurred to date, only contract costs reflecting the work to date should be included in costs incurred to date.

- Exclude costs relating to **future activity**, eg cost of materials delivered but not yet used
- Exclude payments made to subcontractors **in advance** of work performed

2.11 Outcome of the contract cannot be reliably estimated

When the contract's outcome cannot be reliably estimated the following treatment should be followed.

- Only recognise revenue to the extent of contract costs incurred which are expected to be **recoverable**
- Recognise contract costs as an **expense** in the period they are incurred

This **no profit/no loss approach** reflects the situation near the beginning of a contract, ie the outcome cannot be reliably estimated, but it is likely that costs will be recovered.

Contract costs which **cannot be recovered** should be recognised as an expense straight away. IAS 11 lists the following situations where this might occur.

- The contract is **not fully enforceable**, ie its validity is seriously questioned
- The completion of the contract is subject to the outcome of **pending litigation or legislation**
- The contract relates to properties which will probably be **expropriated or condemned**
- The customer is **unable to meet its obligations** under the contract
- The contractor **cannot complete** the contract or in any other way meet its obligations under the contract

Where these **uncertainties cease to exist,** contract revenue and costs should be recognised as normal, ie by reference to the stage of completion.

2.12 Recognition of expected losses

Any loss on a contract should be **recognised as soon as it is foreseen**. The loss will be the amount by which total expected contract revenue is exceeded by total expected contract costs. The loss amount is not affected by whether work has started on the contract, the stage of completion of the work or profits on other contracts (unless they are related contracts treated as a single contract).

2.13 Changes in estimates

The effect of any change in the estimate of contract revenue or costs or the outcome of a contract should be accounted for as a **change in accounting estimate** under IAS 8 *Accounting policies, changes in accounting estimates and errors.*

2.14 Example: changes in estimates

The example below shows the effect of a change in estimate of costs on the figures that appear in the statement of profit or loss and other comprehensive income and statement of financial position.

Battersby Co enters into a three-year contract.

Estimated revenue = $20,000
Estimated total cost = $16,000.

However, during Year 2, management revises its estimate of total costs incurred and thus the outcome of the contract. As a result, during Year 2, a loss is recognised on the contract for the year, even though the contract will still be profitable overall.

	Year 1	*Year 2*	*Year 3*
	$	$	$
Estimated revenue	20,000	20,000	20,000
Estimated total cost	16,000	18,000	18,000
Estimated total profit	4,000	2,000	2,000
Cost incurred to date	$8,000	$13,500	$18,000
Percentage of completion	50%	75%	100%
Recognised profit/(loss) for year	$2,000	($500)	$500
Cumulative recognised profit	$2,000	$1,500	$2,000

Progress billings of $8,000, $8,000 and $4,000 are made on the last day of each year and are received in the first month of the following year. The asset at the end of each year is:

	Year 1	*Year 2*	*Year 3*
	$	$	$
Costs incurred	8,000	13,500	18,000
Recognised profits	2,000	2,000	2,500
(Recognised losses)		(500)	(500)
(Progress billings)	(8,000)	(16,000)	(20,000)
Amount recognised as an asset/(liability)	2,000	(1,000)	0

In addition, at each year end, the entity recognises a trade receivable for the amount outstanding at the end of the year of $8,000, $8,000 and $4,000.

2.15 Section summary

In valuing long-term contracts and the other disclosures required under IAS 11, an organised approach is essential. The following suggested method breaks the process down into five logical steps.

Step 1 **Compare the contract value** and the **total costs** expected to be incurred on the contract. If a loss is foreseen (that is, if the costs to date plus estimated costs to completion exceed the contract value) then it must be charged against profits. If a loss has already been charged in previous years, then only the difference between the loss as previously and currently estimated need be charged.

Step 2 Using the percentage completed to date (or other formula given in the question), calculate sales revenue **attributable** to the contract for the period (for example percentage complete × total contract value, less of course, revenue taken in previous periods).

Step 3 **Calculate the cost of sales** on the contract for the period.

	$
Total contract costs × percentage complete (or follow instructions in question)	X
Less any costs charged in previous periods	(X)
	X
Add foreseeable losses in full (not previously charged)	X
Cost of sales on contract for the period	X

Step 4 **Deduct the cost of sales** for the period as calculated above (including any foreseeable loss) from the sales revenue calculated at step 2 to give profit (loss) recognised for the period.

Step 5 **Calculate amounts due to/from** customers as per the working on the previous page.

	$
Contract costs incurred to date	X
Recognised profits/(losses) to date	X
	X
Progress billings to date	(X)
Amounts due from/(to) customers	X/(X)

Note: This represents unbilled revenue. Unpaid billed revenue will be included in trade receivables.

2.16 Summary of accounting treatment

The following summarises the accounting treatment for long-term contracts – **make sure that you understand it.**

2.16.1 Statement of profit or loss

(a) **Revenue and costs**

(i) Sales revenue and associated costs should be recorded in profit or loss as the contract activity progresses.

(ii) Include an appropriate proportion of total contract value as sales revenue in the statement of profit or loss.

(iii) The costs incurred in reaching that stage of completion are matched with this sales revenue, resulting in the reporting of results which can be attributed to the proportion of work completed.

(iv) Sales revenue is the value of work carried out to date. This is often 'certified' by an independent surveyor. The surveyor may certify that the contract is complete by a % (eg. 60% complete) or may certify the value of the work completed. This may be used as revenue recognised unless another method is being used (such as revenue recognised on basis of costs incurred).

(v) Contract revenue can be affected by penalties arising from delays caused by the contractor. The costs of errors or penalties should be charged in full in the year in which they occur.

(b) **Profit recognised in the contract**

(i) It must reflect the proportion of work carried out.

(ii) It should take into account any known inequalities in profitability in the various stages of a contract.

2.16.2 Statement of financial position

(a) **Current asset/liability**

	$
Costs incurred to date	X
Recognised profits/(losses) to date	(X)
	X
Progress billings to date	(X)
Amount due from / (to)customers	X(X)

(b) **Receivables**

	$
Unpaid progress billings	X

(c) **Payables**. Where (a) gives a net 'amount due to customers' this amount should be included in payables under 'payments on account'.

Exam focus point

There is a *student accountant* article on IAS 11 and IAS 18 that you should read. It is available online here:

http://www.accaglobal.com/uk/en/student/acca-qual-student-journey/qual-resource/acca-qualification/f7/technical-articles/revenue-recognition.html

Question

Construction contract

The main business of Santolina Co is construction contracts. At the end of September 20X3 there is an uncompleted contract on the books, details of which are as follows.

CONTRACT B	
Date commenced	1.4.X1
Expected completion date	23.12.X3
	$
Final contract price	290,000
Costs to 30.9.X3	210,450
Value of work certified to 30.9.X3	230,000
Progress billings to 30.9.X3	210,000
Cash received to 30.9.X3	194,000
Estimated costs to completion at 30.9.X3	20,600

Santolina calculates % completion based on work certified/contract price.

Required

Prepare calculations showing the amount to be included in the statement of profit or loss and statement of financial position at 30 September 20X3 in respect of the above contract.

Answer

Contract B is a construction contract and will be included in the statement of financial position at cost plus recognised profit less progress billings.

The estimated final profit is:

	$
Final contract price	290,000
Less: costs to date	(210,450)
estimated future costs	(20,600)
Estimated final profit	58,950

The recognised profit is found as follows.

$$\text{Estimated final profit} \times \frac{\text{Work certified}}{\text{Total contract price}}$$

$$\$58,950 \times \frac{230,000}{290,000} = \$58,950 \times 79.31\%$$

Profit recognised = $46,753

Statement of profit or loss

	$
Revenue (290,000 × 79.31%)	229,999
Cost of sales ((210,450 + 20,600) × 79.31%)	(183,246)
Gross profit	46,753

Statement of financial position

Gross amount due from customers for contract work

	$
Costs to date	210,450
Attributable profit	46,753
	257,203
Progress billings	(210,000)
Amount due from customers	47,203
Trade receivables (210 – 194)	16,000

Exam focus point

A question is more likely to be set on construction contracts than on inventory, because inventory is a very simple area of the syllabus.

Question

IAS 11 calculations

Haggrun Co has two contracts in progress, the details of which are as follows.

	Happy (profitable)	*Grumpy (loss-making)*
	$'000	$'000
Total contract price	300	300
Costs incurred to date	90	150
Estimated costs to completion	135	225
Progress payments invoiced and received	116	116

Required

Show extracts from the statement of profit or loss and other comprehensive income and the statement of financial position for each contract, assuming they are both:

(a) 40% complete; and
(b) 36% complete.

Answer

Happy contract

(a) *40% complete*

	$'000
Statement of profit or loss	
Revenue (300 × 40%)	120
Cost of sales ((90+ 135) × 40%)	(90)
Profit to date (W)	30

Working

Profit to date

	$'000
Total contract price	300
Costs to date	(90)
Cost to completion	(135)
Total expected profit	75
Profit to date (75 × 40%)	30

Statement of financial position

	$'000
Costs to date	90
Profit recognised to date	30
Progress billings	(116)
Amount due from customers	4

(b) *36% complete*

	$'000
Statement of profit or loss	
Revenue (300 × 36%)	108
Cost of sales (((90 + 135) × 36%))	(81)
Profit to date (75 × 36%)	27
Statement of financial position	
Costs to date	90
Profit recognised to date	27
Progress billings	(116)
Amount due from customers	1

Grumpy contract

(a) *40% complete*

	$'000
Statement of profit or loss	
Revenue (300 × 40%)	120
Cost of sales*	(195)
Foreseeable loss (W)	(75)

Working

	$'000
Total contract revenue	300
Costs to date	(150)
Costs to complete	(225)
Foreseeable loss	(75)
Statement of financial position	
Costs to date	150
Foreseeable loss	(75)
Progress billings	(116)
Amounts due to customers	(41)
* Costs to date (150 + 225) × 40%	150
Forseeable loss (75) × 60%**	45
	195

** The other 40% is taken into account in costs to date. We make this adjustment to bring in the **whole** of the foreseeable loss.

(b) *36% complete*

	$'000
Statement of profit or loss	
Revenue (300 × 36%)	108
Cost of sales*	(183)
Foreseeable loss	(75)
Statement of financial position	
Costs to date	150
Foreseeable loss	(75)
Progress billings	(116)
Amount due to customers	(41)
* Costs to date (150 + 225) × 36%	135
Forseeable loss (75) × 64%**	48
	183

Chapter roundup

- IAS 2 *Inventories* requires that the statement of financial position should show **inventories** classified in a manner appropriate to the entity. Common classifications are:
  - Merchandise
  - Production supplies
  - Materials
  - Work in progress
  - Finished goods
- Full details are required of inventory carried at **NRV** as well as the reversal of any previous write down.
- The use of **LIFO** is **prohibited** under the revised IAS 2.
- Sales revenue on a construction contract is based upon stage of completion.

Quick quiz

1 Net realisable value = Selling price **less** …………………… **less** …………………..

2 Which inventory costing method is allowed under IAS 2?

(a) FIFO
(b) LIFO

3 Any expected loss on a construction contract must be recognised, in full, in the year it was identified.

True ☐

False ☐

4 List the five steps to be taken when valuing construction contracts.

5 Which items in the statement of profit or loss and other comprehensive income and statement of financial position are potentially affected by construction contracts?

Answers to quick quiz

1 Net realisable value = selling price **less** costs to completion **less** costs necessary to make the sale.

2 (a) FIFO. LIFO is not allowed.

3 True

4 See paragraph 2.15

5 Statement of profit or loss and other comprehensive income: revenue and cost of sales.
Statement of financial position: inventories, receivables, payables

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q11	Introductory	n/a	n/a

9

Liabilities – provisions, contingent assets and liabilities

Topic list	Syllabus reference
1 Provisions	B8
2 Provisions for restructuring	B8
3 Contingent liabilities and contingent assets	B8

Introduction

You will have come across provisions and contingencies in your earlier studies or professional work. However, you may be asked in more detail about IAS 37 for this paper.

Study guide

B8	**Liabilities – provisions, contingent assets and liabilities**
(a)	Explain why an accounting standard on provisions is necessary – give examples of previous abuses in this area
(b)	Define provisions, legal and constructive obligations, past events and the transfer of economic benefits
(c)	State when provisions may and may not be made, and how they should be accounted for
(d)	Explain how provisions should be measured
(e)	Define contingent assets and liabilities – give examples and describe their accounting treatment
(f)	Identify and account for: – onerous contracts – environmental and similar provisions
(g)	Discuss the validity of making provisions for future repairs or renewals

1 Provisions

FAST FORWARD

Under IAS 37 a provision should be recognised when:

- An entity has a **present obligation**, legal or constructive
- It is probable that a **transfer of resources embodying economic benefits** will be required to settle it
- A reliable estimate can be made of its amount

1.1 Objective

IAS 37 *Provisions, contingent liabilities and contingent assets* aims to ensure that appropriate **recognition criteria** and **measurement bases** are applied to provisions, contingent liabilities and contingent assets and that **sufficient information** is disclosed in the **notes** to the financial statements to enable users to understand their nature, timing and amount.

1.2 Provisions

Before IAS 37, there was no accounting standard dealing with provisions. Companies wanting to show their results in the most favourable light used to make large 'one off' provisions in years where a high level of underlying profits was generated. These provisions, often known as 'big bath' provisions, were then available to shield expenditure in future years when perhaps the underlying profits were not as good.

In other words, provisions were used for profit smoothing. Profit smoothing is misleading.

Important

The key aim of IAS 37 is to ensure that **provisions are made only** where there are valid grounds for them.

IAS 37 views a provision as a liability.

Key terms

A **provision** is a **liability** of uncertain timing or amount.

A **liability** is a present obligation of the entity arising from past events , the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. *(IAS 37)*

The IAS distinguishes provisions from other liabilities such as trade creditors and accruals. This is on the basis that for a provision there is **uncertainty** about the timing or amount of the future expenditure. Whilst uncertainty is clearly present in the case of certain accruals the uncertainty is generally much less than for provisions.

1.3 Recognition

IAS 37 states that a provision should be **recognised** as a liability in the financial statements when:

- An entity has a **present obligation** (legal or constructive) as a result of a past event
- It is probable that an **outflow of resources embodying economic benefits** will be required to settle the obligation
- A **reliable estimate** can be made of the amount of the obligation

1.4 Meaning of obligation

It is fairly clear what a legal obligation is. However, you may not know what a **constructive obligation** is.

Key term

IAS 37 defines a **constructive obligation** as

'An obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities; and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.'

For instance, an oil company may have an established practice of always making good any environmental damage caused by drilling, even though it is not legally obliged to do so. In this way, it has created a valid expectation that it will do this and it will have to recognise the constructive obligation and make a corresponding provision each time it drills a new well.

1.4.1 Probable transfer of resources

For the purpose of the IAS, a transfer of resources embodying economic benefits is regarded as **'probable'** if the event is **more likely than not** to occur. This appears to indicate a probability of more than 50%. However, the standard makes it clear that where there is a number of similar obligations the probability should be based on considering the population as a whole, rather than one single item.

1.4.2 Example: transfer of resources

If a company has entered into a warranty obligation then the probability of transfer of resources embodying economic benefits may well be extremely small in respect of one specific item. However, when considering the population as a whole the probability of some transfer of resources is quite likely to be much higher. If there is a **greater than 50% probability** of some transfer of economic benefits then a **provision** should be made for the **expected amount**.

1.4.3 Measurement of provisions

Important

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

The estimates will be determined by the **judgement** of the entity's management supplemented by the experience of similar transactions.

Allowance is made for **uncertainty**. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities, ie **expected value**.

Where the provision involves a single item, such as the outcome of a legal case, provision is made **in full** for the most likely outcome.

Question

Warranty

Parker Co sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defect that becomes apparent within the first six months of purchase. The company's past experience and future expectations indicate the following pattern of likely repairs.

% of goods sold	*Defects*	*Cost of repairs if all items suffered from these defects*
		$m
75	None	–
20	Minor	1.0
5	Major	4.0

What is the provision required?

Answer

The cost is found using 'expected values' (75% × $nil) + (20% × $1.0m) + (5% × $4.0m) = $400,000.

Where the effect of the **time value of money** is material, the amount of a provision should be the **present value** of the expenditure required to settle the obligation. An appropriate **discount** rate should be used.

The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Note: You will be given any relevant discount rates in the exam.

Example

A company knows that when it ceases a certain operation in 5 years time it will have to pay environmental cleanup costs of $5m.

The provision to be made now will be the present value of $5m in 5 years time.

The relevant discount rate in this case is 10%.

Therefore a provision will be made for:

	$
$5m × 0.62092*	3,104,600

* The discount rate for 5 years at 10%.

The following year the provision will be:

$5m × 0.68301**	3,415,050
	310,540

** The discount rate for 4 years at 10%

The increase in the second year of $310,450 will be charged to profit or loss. It is referred to as the **unwinding** of the discount. This is accounted for as a finance cost. The original provision of $3,104,600 will be added to the cost of the assets involved in the operation and depreciated over 5 years.

1.4.4 Future events

Future events which are reasonably expected to occur (eg new legislation, changes in technology) may affect the amount required to settle the entity's obligation and should be taken into account.

1.4.5 Expected disposal of assets

Gains from the expected disposal of assets should not be taken into account in measuring a provision.

1.4.6 Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party. If so, the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation.

- The reimbursement should be treated as a separate asset, and the amount recognised should not be greater than the provision itself.
- The provision and the amount recognised for reimbursement may be netted off in profit or loss.

1.4.7 Changes in provisions

Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of resources will be required to settle the obligation, the provision should be reversed.

1.4.8 Use of provisions

A provision should be used only for expenditures for which the provision was originally recognised. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

1.4.9 Future operating losses

Provisions should not be recognised for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard.

1.4.10 Onerous contracts

If an entity has a contract that is onerous, the present obligation under the contract **should be recognised and measured** as a provision. An example might be vacant leasehold property. The entity holding the lease is under an obligation to maintain the property but is receiving no income or benefit from it.

Key term

> An **onerous contract** is a contract entered into with another party under which the unavoidable costs of fulfilling the terms of the contract exceed any revenues expected to be received from the goods or services supplied or purchased directly or indirectly under the contract and where the entity would have to compensate the other party if it did not fulfil the terms of the contract.

1.5 Examples of possible provisions

It is easier to see what IAS 37 is driving at if you look at examples of those items which are possible provisions under this standard. Some of these we have already touched on.

(a) **Warranties**. These are argued to be genuine provisions as on past experience it is probable, ie more likely than not, that some claims will emerge. The provision must be estimated, however, on the basis of the class as a whole and not on individual claims. There is a clear legal obligation in this case.

(b) **Major repairs**. In the past it has been quite popular for companies to provide for expenditure on a major overhaul to be accrued gradually over the intervening years between overhauls. Under IAS 37 this is no longer possible as IAS 37 would argue that this is a mere intention to carry out repairs, not an obligation. The entity can always sell the asset in the meantime. The only solution is to treat major assets such as aircraft, ships, furnaces etc as a series of smaller assets where each part is depreciated over shorter lives. Thus any major overhaul may be argued to be replacement and therefore capital rather than revenue expenditure. (Chapter 4 Section 1 on component depreciation)

(c) **Self insurance**. A number of companies have created a provision for self insurance based on the expected cost of making good fire damage etc instead of paying premiums to an insurance company. Under IAS 37 this provision is no longer justifiable as the entity has no obligation until a fire or accident occurs. No obligation exists until that time.

(d) **Environmental contamination**. If the company has an environmental policy such that other parties would expect the company to clean up any contamination or if the company has broken current environmental legislation then a provision for environmental damage must be made.

(e) **Decommissioning or abandonment costs**. When an oil company initially purchases an oilfield it is put under a legal obligation to decommission the site at the end of its life. Prior to IAS 37 most oil companies set up the provision gradually over the life of the field so that no one year would be unduly burdened with the cost.

IAS 37, however, insists that a legal obligation exists on the initial expenditure on the field and therefore a liability exists immediately. This would appear to result in a large charge to profit and loss in the first year of operation of the field. However, the IAS takes the view that the cost of purchasing the field in the first place is not only the cost of the field itself but also the costs of putting it right again. Thus all the costs of decommissioning may be capitalised.

(f) **Restructuring**. This is considered in detail below.

Exam focus point

These examples are the sort of situation you may get in the exam.

2 Provisions for restructuring

FAST FORWARD

One of the main purposes of IAS 37 was to target abuses of provisions for restructuring. Accordingly, IAS 37 lays down **strict criteria** to determine when such a provision can be made.

Key term

IAS 37 defines a **restructuring** as:

A programme that is planned and is controlled by management and materially changes one of two things.

- The scope of a business undertaken by an entity
- The manner in which that business is conducted

The IAS gives the following **examples** of events that may fall under the definition of restructuring.

- The **sale or termination** of a line of business
- The **closure of business locations** in a country or region or the **relocation** of business activities from one country region to another
- **Changes in management structure**, for example, the elimination of a layer of management
- **Fundamental reorganisations** that have a material effect on the **nature and focus** of the entity's operations

The question is whether or not an entity has an obligation – legal or constructive – at the end of the reporting period. For this to be the case:

- An entity must have a **detailed formal plan** for the restructuring
- It must have **raised a valid expectation** in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it

Important

A mere management decision is not normally sufficient. Management decisions may sometimes trigger recognition, but only if earlier events such as negotiations with employee representatives and other interested parties have been concluded subject only to management approval.

Where the restructuring involves the **sale of an operation** then IAS 37 states that no obligation arises until the entity has entered into a **binding sale agreement**. This is because until this has occurred the entity will be able to change its mind and withdraw from the sale even if its intentions have been announced publicly.

2.1 Costs to be included within a restructuring provision

The IAS states that a restructuring provision should include only the **direct expenditures** arising from the restructuring, which are those that are both:

- **Necessarily entailed** by the restructuring; and
- Not associated with the **ongoing activities** of the entity.

The following costs should specifically **not** be included within a restructuring provision.

- **Retraining** or relocating continuing staff
- **Marketing**
- **Investment in new systems** and distribution networks

2.2 Disclosure

Disclosures for provisions fall into two parts.

- Disclosure of details of the **change in carrying value** of a provision from the beginning to the end of the year
- Disclosure of the **background** to the making of the provision and the uncertainties affecting its outcome

Question — Provision

In which of the following circumstances might a provision be recognised?

(a) On 13 December 20X9 the board of an entity decided to close down a division. The accounting date of the company is 31 December. Before 31 December 20X9 the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

(b) The board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees.

(c) A company is obliged to incur clean up costs for environmental damage (that has already been caused).

(d) A company intends to carry out future expenditure to operate in a particular way in the future.

Answer

(a) No provision would be recognised as the decision has not been communicated.

(b) A provision would be made in the 20X9 financial statements.

(c) A provision for such costs is appropriate.

(d) No present obligation exists and under IAS 37 no provision would be appropriate. This is because the entity could avoid the future expenditure by its future actions, maybe by changing its method of operation.

3 Contingent liabilities and contingent assets

FAST FORWARD

An entity should not **recognise** a contingent asset or liability, but they should be **disclosed**.

Now you understand provisions it will be easier to understand contingent assets and liabilities.

Key term

IAS 37 defines a **contingent liability** as:

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- A present obligation that arises from past events but is not recognised because:
  - It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - The amount of the obligation cannot be measured with sufficient reliability.

As a rule of thumb, probable means more than 50% likely. If an obligation is probable, it is not a contingent liability – instead, a provision is needed.

3.1 Treatment of contingent liabilities

Contingent liabilities **should not be recognised in financial statements** but they **should be disclosed**. The required disclosures are:

- A brief description of the nature of the contingent liability
- An estimate of its financial effect
- An indication of the uncertainties that exist
- The possibility of any reimbursement

3.2 Contingent assets

Key term

IAS 37 defines a **contingent asset** as:

A possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within control of the entity.

A contingent asset must not be recognised. Only when the realisation of the related economic benefits is **virtually certain** should recognition take place. At that point, **the asset is no longer a contingent asset**!

3.3 Example

A company is engaged in a legal dispute. The outcome is not yet known. A number of possibilities arise:

- It expects to have to pay about $100,000. **A provision is recognised**.
- Possible damages are $100,000 but it is not expected to have to pay them. **A contingent liability is disclosed**.
- The company expects to have to pay damages but is unable to estimate the amount. **A contingent liability is disclosed**.
- The company expects to receive damages of $100,000 and this is virtually certain. **An asset is recognised**.
- The company expects to probably receive damages of $100,000. **A contingent asset is disclosed**.
- The company thinks it may receive damages, but it is not probable. **No disclosure**.

Exam focus point

A legal dispute formed the basis of a question part in the December 2012 paper, with a company expecting to lose a court case but also to be covered by an insurance policy (the liability was probable and therefore provided for, but the asset was not recognised because it was not virtually certain – although disclosure was appropriate).

3.4 Disclosure

3.4.1 Disclosure: contingent liabilities

A **brief description** must be provided of all material contingent liabilities unless they are likely to be remote. In addition, provide

- An estimate of their **financial effect**
- Details of **any uncertainties**
- The possibility of any reimbursement

3.4.2 Disclosure: contingent assets

Contingent assets must only be disclosed in the notes if they are **probable**. In that case a brief description of the contingent asset should be provided along with an estimate of its likely financial effect.

3.5 'Let out'

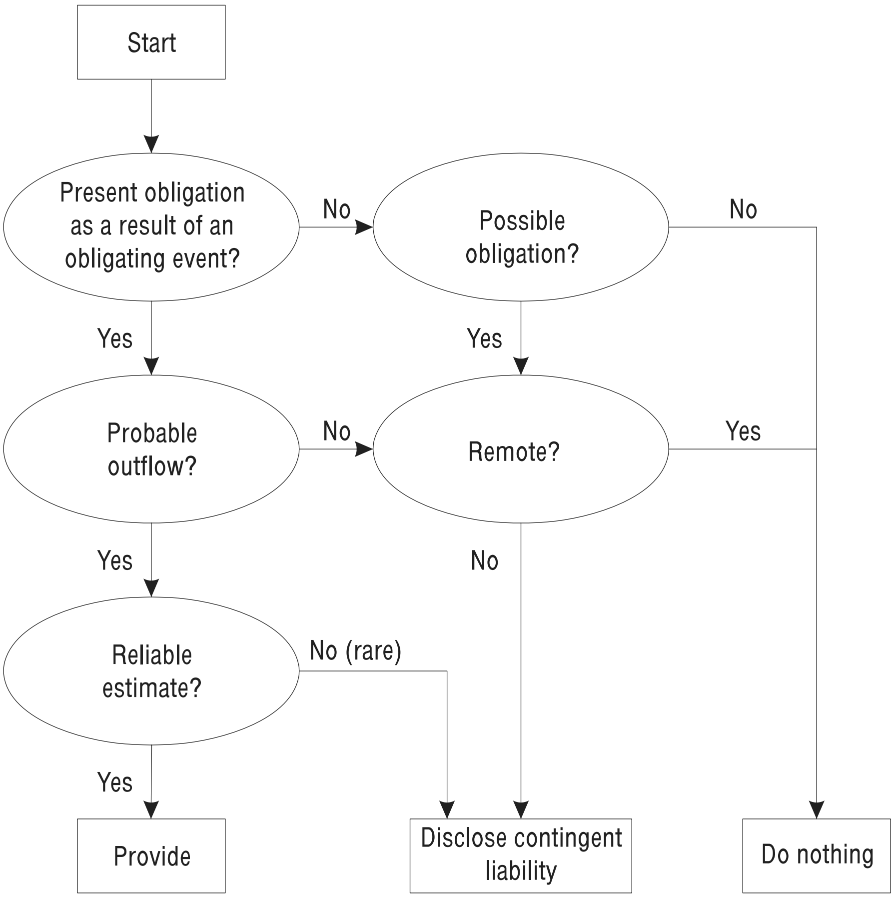
IAS 37 permits reporting entities to avoid disclosure requirements relating to provisions, contingent liabilities and contingent assets if they would be expected to **seriously prejudice** the position of the entity in dispute with other parties. However, this should only be employed in **extremely rare** cases. Details of the general nature of the provision/contingencies must still be provided, together with an explanation of why it has not been disclosed.

3.6 Flow chart

You must practise the questions below to get the hang of IAS 37. But first, study the flow chart, taken from IAS 37, which is a good summary of its requirements concerning provisions and contingent liabilities.

Exam focus point

If you know this flow chart you should be able to deal with most questions you are likely to see in an exam.



Question

Accounting treatment

During 20X0 Smack Co gives a guarantee of certain borrowings of Pony Co, whose financial condition at that time is sound. During 20X1, the financial condition of Pony Co deteriorates and at 30 June 20X1 Pony Co files for protection from its creditors.

What accounting treatment is required:

(a) At 31 December 20X0?
(b) At 31 December 20X1?

Answer

(a) *At 31 December 20X0*

There is a present obligation as a result of a past obligating event. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. However, at 31 December 20X0 no transfer of resources is probable in settlement of the obligation.

No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

(b) *At 31 December 20X1*

As above, there is a present obligation as a result of a past obligating event, namely the giving of the guarantee.

At 31 December 20X1 it is probable that a transfer of resources will be required to settle the obligation. A provision is therefore recognised for the best estimate of the obligation.

Question

Recognition of provision

Warren Co gives warranties at the time of sale to purchasers of its products. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within a period of three years from the date of the sale. Should a provision be recognised?

Answer

Warren Co **cannot avoid** the cost of repairing or replacing all items of product that manifest manufacturing defects in respect of which warranties are given before the end of the reporting period, and a provision for the cost of this should therefore be made.

Warren Co is obliged to repair or replace items that fail within the entire warranty period. Therefore, in respect of **this year's sales**, the obligation provided for at the end of the reporting period should be the cost of making good items for which defects have been notified but not yet processed, **plus** an estimate of costs in respect of the other items sold for which there is sufficient evidence that manufacturing defects **will** manifest themselves during their remaining periods of warranty cover.

Question

Accounting treatment

After a wedding in 20X0 ten people died, possibly as a result of food poisoning from products sold by Callow Co. Legal proceedings are started seeking damages from Callow but it disputes liability. Up to the date of approval of the financial statements for the year to 31 December 20X0, Callow's lawyers advise that it is probable that it will not be found liable. However, when Callow prepares the financial statements for the year to 31 December 20X1 its lawyers advise that, owing to developments in the case, it is probable that it will be found liable.

What is the required accounting treatment:

(a) At 31 December 20X0?
(b) At 31 December 20X1?

Answer

(a) *At 31 December 20X0*

On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events. No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

(b) *At 31 December 20X1*

On the basis of the evidence available, there is a present obligation. A transfer of resources in settlement is probable.

A provision is recognised for the best estimate of the amount needed to settle the present obligation.

3.7 Summary

- The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingencies and that sufficient information is disclosed.
- The IAS seeks to ensure that provisions are **only recognised** when a **measurable obligation** exists. It includes detailed rules that can be used to ascertain when an obligation exists and how to measure the obligation.
- The standard attempts to **eliminate** the **'profit smoothing'** which has gone on before it was issued.

Chapter Roundup

- Under IAS 37, a provision should be recognised when:
  - When an entity has a **present obligation**, legal or constructive
  - It is probable that a **transfer of resources embodying economic benefits** will be required to settle it
  - A **reliable estimate** can be made of its amount
- One the main purposes of IAS 37 was to target abuses of provisions for restructuring. Accordingly, IAS 37 lays down **strict criteria** to determine when such a provision can be made.
- An entity should not **recognise** a contingent asset or liability, but they should be **disclosed**.

Quick Quiz

1 A provision is a …………………… of …………….. timing or amount.

2 A programme is undertaken by management which converts the previously wholly owned chain of restaurants they ran into franchises. Is this restructuring?

3 Define contingent asset and contingent liability.

4 How should decommissioning costs on an oilfield be accounted for under IAS 37?

5 'Provisions for major overhauls should be accrued for over the period between overhauls'. Is this correct?

Answers to Quick Quiz

1 Liability of uncertain timing or amount

2 Yes. The manner in which the business is conducted has changed

3 Refer to paragraphs 3.1 and 3.2

4 They should be capitalised as part of the initial expenditure on the oilfield.

5 No. It is not correct. See paragraph 1.5.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q12	Examination	25	45 mins

10

Employee benefits

Topic list	Syllabus reference
1 IAS 19 *Employee benefits*	B9
2 Short-term employee benefits	B9
3 Post-employment benefits	B9
4 Defined contribution plans	B9
5 Defined benefit plans: recognition and measurement	B9
6 Defined benefit plans: other matters	B9
7 Other long-term benefits	B9
8 Disclosures	B9

Introduction

An increasing number of companies and other entities now provide a **pension and other employee benefits** as part of their employees' remuneration package. In view of this trend, it is important that there is standard best practice for the way in which employee benefit costs are **recognised, measured, presented and disclosed** in the sponsoring entities' accounts. Remember that we are talking about accounting by the employer, not the benefit scheme or plan.

Study guide

B9	**Accounting for employment and post-employment benefit costs**
(a)	Describe the nature of defined contribution, multi-employers and defined benefits schemes
(b)	Explain the recognition and measurement of defined benefit schemes under current proposals
(c)	Account for defined benefit schemes including the amounts shown in the financial statements, (and notes to the accounts)

1 IAS 19 *Employee benefits*

FAST FORWARD

IAS 19 *Employee benefits* is a long and complex standard covering both short-term and long-term (post-employment) benefits. The complications arise when dealing with **post-employment benefits**.

Exam focus point

This is a very difficult topic – employee benefit costs are inherently complex and their accounting is both **problematic and controversial**.

IAS 19 *Employee benefits* has been revised several times. The latest version was issued in June 2011. The reason for the revision was to address some of the main criticisms of the previous methods of accounting for pensions. Before we look at IAS 19, we should consider the nature of employee benefit costs and why there is an accounting problem which must be addressed by a standard.

1.1 The conceptual nature of employee benefit costs

When a company or other entity employs a new worker, that worker will be offered a **package of pay and benefits**. Some of these will be short-term and the employee will receive the benefit at about the same time as he or she earns it, for example basic pay, overtime and so on. Other employee benefits are **deferred**, however, the main example being retirement benefits (ie a pension).

The cost of these deferred employee benefits to the employer can be viewed in various ways. They could be described as **deferred salary** to the employee. Alternatively, they are a **deduction** from the employee's true gross salary, used as a tax-efficient means of saving. In some countries, tax efficiency arises on retirement benefit contributions because they are not taxed on the employee, but they are allowed as a deduction from taxable profits of the employer.

1.2 Accounting for employee benefit costs

Accounting for **short-term employee benefit costs** tends to be quite straightforward, because they are simply recognised as an expense in the employer's financial statements of the current period.

Accounting for the cost of **deferred employee benefits** is much more difficult. This is because of the large amounts involved, as well as the long time scale, complicated estimates and uncertainties. In the past, entities accounted for these benefits simply by charging profit or loss of the employing entity on the basis of actual payments made. This led to substantial variations in reported profits of these entities and disclosure of information on these costs was usually sparse.

1.3 IAS 19 Employee benefits

IAS 19 is intended to prescribe the following.

(a) When the cost of employee benefits should be **recognised as a liability or an expense**
(b) The **amount** of the liability or expense that should be recognised

As a basic rule, the standard states the following.

(a) A **liability** should be recognised when an employee has provided a service in exchange for benefits to be received by the employee at some time in the future.

(b) An **expense** should be recognised when the entity consumes the economic benefits from a service provided by an employee in exchange for employee benefits.

The basic problem is therefore fairly straightforward. An entity will often enjoy the **economic benefits** from the services provided by its employees in advance of the employees receiving all the employment benefits from the work they have done, for example they will not receive pension benefits until after they retire.

1.4 Categories of employee benefits

The standard recognises five categories of employee benefits, and proposes a different accounting treatment for each. These four categories are as follows.

1. **Short-term benefits** including, if expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services:
   - Wages and salaries
   - Social security contributions
   - Paid annual leave
   - Paid sick leave
   - Paid maternity/paternity leave
   - Profit shares and bonuses
   - Paid jury service
   - Paid military service
   - Non-monetary benefits, eg medical care, housing, cars, free or subsidised goods
2. **Post-employment benefits**, eg pensions and post-employment medical care and post-employment insurance
3. **Other long-term benefits**, eg profit shares, bonuses or deferred compensation payable later than 12 months after the year end, sabbatical leave, long-service benefits and long-term disability benefits
4. **Termination benefits**, eg early retirement payments and redundancy payments

Benefits may be paid to the employees themselves, to their dependants (spouses, children, etc) or to third parties.

1.5 Definitions

IAS 19 uses a great many important definitions. This section lists those that relate to the different categories of employee benefits.

Key terms

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment.

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

Key terms (cont'd)

Termination benefits are employee benefits provided in exchange for the termination of an employee's employment as a result of either:

(a) an entity's decision to terminate an employee's employment before the normal retirement date, or

(b) an employee's decision to accept an offer of benefits in exchange for the termination of employment.

2 Short-term employee benefits

FAST FORWARD

The accounting for **short term employee benefits** is simple. The principles are the same as for any expense that is accrued over a period.

Accounting for short-term employee benefits is fairly straightforward, because there are **no actuarial assumptions** to be made, and there is **no requirement to discount** future benefits (because they are all, by definition, payable no later than 12 months after the end of the accounting period).

2.1 Recognition and measurement

The rules for short-term benefits are essentially an application of **basic accounting principles and practice**.

(a) **Unpaid short-term employee benefits** as at the end of an accounting period should be recognised as an accrued expense. Any short-term benefits **paid in advance** should be recognised as a prepayment (to the extent that it will lead to, eg a reduction in future payments or a cash refund).

(b) The **cost of short-term employee benefits** should be recognised as an **expense** in the period when the economic benefit is given, as employment costs (except insofar as employment costs may be included within the cost of an asset, eg property, plant and equipment).

2.2 Short-term paid absences

There may be **short-term accumulating paid absences**. These are absences for which an employee is paid, and if the employee's entitlement has not been used up at the end of the period, they are carried forward to the next period. An example is paid holiday leave, where any unused holidays in one year are carried forward to the next year. The cost of the benefits of such absences should be **charged as an expense** as the employees render service that increases their entitlement to future compensated absences.

There may be **short-term non-accumulating paid absences**. These are absences for which an employee is paid when they occur, but an **entitlement to the absences does not accumulate**. The employee can be absent, and be paid, but only if and when the circumstances arise. Examples are maternity/paternity pay, (in most cases) sick pay, and paid absence for jury service.

2.3 Measurement

The cost of accumulating paid absences should be measured as the additional amount that the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period.

2.4 Example: Unused holiday leave

A company gives its employees an annual entitlement to paid holiday leave. If there is any unused leave at the end of the year, employees are entitled to carry forward the unused leave for up to 12 months. At the end of 20X9, the company's employees carried forward in total 50 days of unused holiday leave. Employees are paid $100 per day.

Required

State the required accounting for the unused holiday carried forward.

Solution

The short-term accumulating paid absences should be recognised as a cost in the year when the entitlement arises, ie in 20X9.

Question — **Sick leave**

Plyman Co has 100 employees. Each is entitled to five working days of paid sick leave for each year, and unused sick leave can be carried forward for one year. Sick leave is taken on a LIFO basis (ie first out of the current year's entitlement and then out of any balance brought forward).

As at 31 December 20X8, the average unused entitlement is two days per employee. Plyman Co expects (based on past experience which is expected to continue) that 92 employees will take five days or less sick leave in 20X9, the remaining eight employees will take an average of 6½ days each.

Required

State the required accounting for sick leave.

Answer

Plyman Co expects to pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X8, ie 1½ days × 8 employees. Plyman Co should recognise a liability equal to 12 days of sick pay.

2.5 Profit sharing or bonus plans

Profit shares or bonuses payable within 12 months after the end of the accounting period should be recognised as an expected cost when the entity has a **present obligation to pay it**, ie when the employer has no real option but to pay it. This will usually be when the employer recognises the profit or other performance achievement to which the profit share or bonus relates. The measurement of the constructive obligation reflects the possibility that some employees may leave without receiving a bonus.

2.6 Example: Profit sharing plan

Mooro Co runs a profit sharing plan under which it pays 3% of its net profit for the year to its employees if none have left during the year. Mooro Co estimates that this will be reduced by staff turnover to 2.5% in 20X9.

Required

Which costs should be recognised by Mooro Co for the profit share?

Solution

Mooro Co should recognise a liability and an expense of 2.5% of net profit.

2.7 Disclosure

There are **no specific disclosure requirements for short-term employee benefits** in the standard.

3 Post-employment benefits

FAST FORWARD

There are **two types of post-employment benefit plan**:

- Defined contribution plans
- Defined benefit plans

Defined contribution plans are simple to account for as the benefits are defined by the contributions made.

Defined benefit plans are much more difficult to deal with as the benefits are promised, they define the contributions to be made.

Many employers provide post-employment benefits for their employees after they have stopped working. **Pension schemes** are the most obvious example, but an employer might provide post-employment death benefits to the dependants of former employees, or post-employment medical care.

Post-employment benefit schemes are often referred to as '**plans**'. The 'plan' receives regular contributions from the employer (and sometimes from current employees as well) and the money is invested in assets, such as stocks and shares and other investments. The post-employment benefits are paid out of the income from the plan assets (dividends, interest) or from money from the sale of some plan assets.

3.1 Definitions

IAS 19 sets out the following definitions relating to classification of plans.

Key terms

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Multi-employer plans are defined contribution plans (other than State plans) or defined benefit plans (other than State plans) that:

(a) Pool the assets contributed by various entities that are not under common control, and
(b) Use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

There are two types or categories of post-employment benefit plan, as given in the definitions above.

(a) **Defined contribution plans**. With such plans, the employer (and possibly current employees too) pay regular contributions into the plan of a given or 'defined' amount each year. The contributions are invested, and the size of the post-employment benefits paid to former employees depends on how well or how badly the plan's investments perform. If the investments perform well, the plan will be able to afford higher benefits than if the investments performed less well.

(b) **Defined benefit plans**. With these plans, the size of the post-employment benefits is determined in advance, ie the benefits are 'defined'. The employer (and possibly current employees too) pay contributions into the plan, and the contributions are invested. The size of the contributions is set at an amount that is expected to earn enough investment returns to meet the obligation to pay the post-employment benefits. If, however, it becomes apparent that the assets in the fund are insufficient, the employer will be required to make additional contributions into the plan to make up the expected shortfall. On the other hand, if the fund's assets appear to be larger than they need to be, and in excess of what is required to pay the post-employment benefits, the employer may be allowed to take a 'contribution holiday' (ie stop paying in contributions for a while).

It is important to make a clear distinction between the following.

- **Funding** a defined benefit plan, ie paying contributions into the plan
- **Accounting for** the cost of funding a defined benefit plan

The key difference between the two types of plan is the nature of the 'promise' made by the entity to the employees in the scheme:

(a) Under a **defined contribution** plan, the 'promise' is to pay the agreed amount of contributions, Once this is done, the entity has no further liability and no exposure to risks related to the performance of the assets held in the plan.

(b) Under a **defined benefit** plan, the 'promise' is to pay the amount of benefits agreed under the plan. The entity is taking on a far more uncertain liability that may change in future as a result of many variables and has continuing exposure to risks related to the performance of assets held in the plan. In simple terms, of the plan assets are insufficient to meet the plan liabilities to pay pensions in future, the entity will have to make up any deficit.

3.2 Multi-employer plans

These were defined above. IAS 19 requires an entity to **classify** such a plan as a defined contribution plan or a defined benefit plan, depending on its terms (including any constructive obligation beyond those terms).

For a multi-employer plan that is a **defined benefit plan**, the entity should account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan and make full disclosure.

When there is **insufficient information** to use defined benefit accounting, then the multi-employer plan should be accounted for as a defined contribution plan and additional disclosures made (that the plan is in fact a defined benefit plan and information about any known surplus or deficit).

3.3 Section summary

- There are two categories of **post-retirement benefits**:
  - Defined contribution schemes
  - Defined benefit schemes
- **Defined contribution schemes** provide benefits commensurate with the fund available to produce them.
- **Defined benefit schemes** provide promised benefits and so contributions are based on estimates of how the fund will perform.
- **Defined contribution scheme costs** are easy to account for and this is covered in the next section.

4 Defined contribution plans

A typical defined contribution plan would be where the employing company agreed to contribute an amount of, say, 5% of employees' salaries into a post-employment plan.

Accounting for payments into defined contribution plans is straightforward.

(a) The **obligation** is measured by the amounts to be contributed for that period.
(b) There are no actuarial assumptions to make.
(c) If the obligation is settled in the current period (or at least no later than 12 months after the end of the current period) there is **no requirement for discounting**.

IAS 19 requires the following.

(a) **Contributions** to a defined contribution plan should be recognised as an **expense** in the period they are payable (except to the extent that labour costs may be included within the cost of assets).
(b) Any liability for **unpaid contributions** that are due as at the end of the period should be recognised as a **liability** (accrued expense).
(c) Any **excess contributions** paid should be recognised as an asset (prepaid expense), but only to the extent that the prepayment will lead to, eg a reduction in future payments or a cash refund.

In the (unusual) situation where contributions to a defined contribution plan do not fall due entirely within 12 months after the end of the period in which the employees performed the related service, then these should be **discounted**. The discount rate to be used is discussed below in Paragraphs 5.22 and 5.23.

Disclosure requirements

(a) A **description** of the plan
(b) The amount recognised as an **expense** in the period

5 Defined benefit plans: recognition and measurement

Accounting for defined benefit plans is much more complex. The complexity of accounting for defined benefit plans stems largely from the following factors.

(a) The future benefits (arising from employee service in the current or prior years) **cannot be measured exactly**, but whatever they are, the fund (kept solvent by the employer) will have to pay them, and the liability should therefore be recognised now. To measure these future obligations, it is necessary to use **actuarial assumptions**.
(b) The obligations payable in future years should be valued, by discounting, on a **present value** basis. This is because the obligations may be settled in many years' time.
(c) If actuarial assumptions change, the amount of required contributions to the fund will change, and there may be **actuarial gains or losses**. A contribution into a fund in any period will not equal the expense for that period, due to actuarial gains or losses.

IAS 19 defines the following key terms to do with defined benefit plans.

Key terms

The **net defined benefit liability (asset)** is the deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

The **deficit or surplus** is:

(a) the present value of the defined benefit obligation less

(b) the fair value of plan assets (if any).

The **asset ceiling** is the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

The **present value of a defined benefit** obligation is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Plan assets comprise:

(a) Assets held by a long-term employee benefit fund; and

(b) Qualifying insurance policies

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

(a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

(b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:
  (i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or
  (ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

5.1 Outline of the method

FAST FORWARD

There is a **four-step method** for recognising and measuring the expenses and liability of a defined benefit pension plan.

An outline of the method used by an employer to account for the expenses and obligation of a defined benefit plan is given below. The stages will be explained in more detail later.

Step 1 **Measure the deficit or surplus**:

(a) An **actuarial technique** (the **Projected Unit Credit Method**), should be used to make a reliable estimate of the amount of future benefits employees have earned from service in relation to the current and prior years. The entity must determine how much benefit should be attributed to service performed by employees in the current period, and in prior periods. Assumptions include, for example, assumptions about employee turnover, mortality rates, future increases in salaries (if these will affect the eventual size of future benefits such as pension payments).

(b) The benefit should be **discounted** to arrive at the present value of the defined benefit obligation and the current service cost.

(c) The **fair value** of any **plan assets** should be deducted from the present value of the defined benefit obligation.

Step 2 The surplus or deficit measured in Step 1 may have to be adjusted if a net benefit asset has to be restricted by the **asset ceiling**.

Step 3 Determine the amounts to be recognised in **profit or loss**:

(a) **Current service cost**
(b) Any **past service cost** and **gain or loss on settlement**
(c) **Net interest** on the **net defined benefit liability (asset)**

Step 4 Determine the **re-measurements** of the **net defined benefit liability (asset)**, to be recognised in **other comprehensive income** (items that will **not be reclassified to profit or loss**):

(a) **Actuarial gains and losses**

(b) **Return on plan assets** (excluding amounts included in net interest on the net defined benefit liability (asset))

(c) Any change in the effect of the **asset ceiling** (excluding amounts included in net interest on the net defined benefit liability (asset))

5.2 Constructive obligation

IAS 19 makes it very clear that it is not only its legal obligation under the formal terms of a defined benefit plan that an entity must account for, but also for any **constructive obligation** that it may have. A constructive obligation, which will arise from the entity's informal practices, exist when the entity has no realistic alternative but to pay employee benefits, for example if any change in the informal practices would cause unacceptable damage to employee relationships.

5.3 The Projected Unit Credit Method

With this method, it is assumed that each period of service by an employee gives rise to an **additional unit of future benefits**. The present value of that unit of future benefits can be calculated, and attributed to the period in which the service is given. The units, each measured separately, build up to the overall obligation. The accumulated present value of (discounted) future benefits will incur interest over time, and an interest expense should be recognised.

These calculations are complex and would normally be carried out by an actuary. In the exam, you will be given the figures but the following example (from IAS 19) is included to explain the method.

5.4 Example: Defined benefit obligations and current service cost

A lump sum benefit is payable on termination of service and equal to 1% of final salary for each year of service. The salary in year 1 is $10,000 and is assumed to increase at 7% (compound) each year. The discount rate used is 10% per year. The following table shows how the obligation builds up for an employee who is expected to leave at the end of year 5, assuming that there are no changes in actuarial assumptions. For simplicity, this example ignores the additional adjustment needed to reflect the probability that the employee may leave the entity at an earlier or later date.

Year	1	2	3	4	5
	$	$	$	$	$
Benefit attributed to:					
Prior years	0	131	262	393	524
Current year (1% × final salary)	131	131	131	131	131
Current and prior years	131	262	393	524	655
Opening obligation	-	89	196	324	476
Interest at 10%	-	9	20	33	48
Current service cost	89	98	108	119	131
Closing obligation	89	196	324	476	655

Notes:

(1) The opening obligation is the present value of the benefit attributed to prior years.

(2) The current service cost is the present value of the benefit attributed to the current year.

(3) The closing obligation is the present value of the benefit attributed to current and prior years.

5.5 Actuarial assumptions

Actuarial assumptions are needed **to estimate the size of the future (post-employment) benefits** that will be payable under a defined benefits scheme. The main categories of actuarial assumptions are as follows.

(a) **Demographic assumptions** are about mortality rates before and after retirement, the rate of employee turnover, early retirement, claim rates under medical plans for former employees, and so on.

(b) **Financial assumptions** include future salary levels (allowing for seniority and promotion as well as inflation) and the future rate of increase in medical costs (not just inflationary cost rises, but also cost rises specific to medical treatments and to medical treatments required given the expectations of longer average life expectancy).

The standard requires actuarial assumptions to be neither too cautious nor too imprudent: they should be **'unbiased'**. They should also be based on **'market expectations'** at the year end, over the period during which the obligations will be settled.

5.6 The statement of financial position

In the statement of financial position, the amount recognised as a **defined benefit liability** (which may be a negative amount, ie an asset) should be the following.

(a) The **present value of the defined obligation** at the year end, **minus**

(b) The **fair value of the assets of the plan** as at the year end (if there are any) out of which the future obligations to current and past employees will be directly settled.

The earlier parts of this section have looked at the recognition and measurement of the defined benefit obligation. Now we will look at issues relating to the assets held in the plan.

5.7 Plan assets

Plan assets are:

(a) Assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits.

(b) Insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits.

Investments which may be used for purposes other than to pay employee benefits are not plan assets.

The standard requires that the plan assets are measured at fair value, as 'the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date'. You may spot that this definition is slightly different to the revised definition in accordance with IFRS 13 *Fair value measurement* (see Chapter 11). The two standards were being updated around the same time so the definitions are currently out of step but this should make no difference to the practicalities you will have to deal with in questions, where the fair value is normally stated in the scenario information.

IAS 19 includes the following **specific requirements**:

(a) The plan assets should exclude any contributions due from the employer but not yet paid.

(b) Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, such as trade and other payables.

5.8 The statement of profit or loss and other comprehensive income

All of the gains and losses that affect the plan obligation and plan asset must be recognised. The **components of defined benefit cost must be recognised as follows** in the statement of profit or loss and other comprehensive income:

Component	*Recognised in*
(a) Service cost	Profit or loss
(b) Net interest on net defined benefit liability	Profit or loss
(c) Re-measurements of net defined benefit liability	Other comprehensive income (not reclassified to P/L)

5.9 Service costs

These comprise:

(a) **Current service cost**, this is the increase in the present value of the defined benefit obligation resulting from employee services during the period. The measurement and recognition of this cost was introduced in Section 5.1.

(b) **Past service cost**, which is the change in the obligation relating to service in **prior periods**. This results from amendments or curtailments to the pension plan, and

(c) Any **gain or loss on settlement**.

The detail relating to points (b)and (c) above will be covered in a later section. First, we will continue with the basic elements of accounting for defined benefit pension costs.

5.10 Net interest on the defined benefit liability (asset)

In Section 5.1 we looked at the recognition and measurement of the defined benefit obligation. This figure is the discounted **present value** of the future benefits payable. Every year the discount must be 'unwound', increasing the present value of the obligation as time passes through an interest charge.

5.10.1 Interest calculation

IAS 19 requires that the interest should be calculated on the **net defined benefit liability (asset)**. This means that the amount recognised in profit or loss is the net of the interest charge on the obligation and the interest income recognised on the assets.

The calculation is as follows:

Net defined benefit liability/(asset) × **Discount rate**

The **net defined benefit liability/(asset)** should be measured as at the **start** of the accounting period, taking account of changes during the period as a result of contributions paid into the scheme and benefits paid out.

Many exam questions include the assumption that all payments into and out of the scheme take place at the end of the year, so that the interest calculations can be based on the opening balances.

5.10.2 Discount rate

The **discount rate** adopted should be determined by reference to **market yields** on high quality fixed-rate corporate bonds. In the absence of a 'deep' market in such bonds, the yields on comparable government bonds should be used as reference instead. The maturity of the corporate bonds that are used to determine a discount rate should have a term to maturity that is consistent with the expected maturity of the post-employment benefit obligations, although a single weighted average discount rate is sufficient.

The guidelines comment that there may be some difficulty in obtaining a **reliable yield for long-term maturities**, say 30 or 40 years from now. This should not, however, be a significant problem: the present value of obligations payable in many years time will be relatively small and unlikely to be a significant proportion of the total defined benefit obligation. The total obligation is therefore unlikely to be sensitive to errors in the assumption about the discount rate for long-term maturities (beyond the maturities of long-term corporate or government bonds).

5.11 Re-measurements of the net defined benefit liability

Re-measurements of the net defined benefit liability/(asset) comprise:

(a) Actuarial gains and losses;

(b) The return on plan assets, (excluding amounts included in net interest on the net defined benefit liability/(asset)); and

(c) Any change in the effect of the asset ceiling, (excluding amounts included in net interest on the net defined benefit liability/(asset)).

The gains and losses relating to points (a) and (b) above will arise in every defined benefit scheme so we will look at these in this section. The asset ceiling is a complication that is not relevant in every case, so it is dealt with separately, later in the chapter.

5.11.1 Actuarial gains and losses

At the end of each accounting period, a new valuation, using updated assumptions, should be carried out on the obligation. Actuarial gains or losses arise because of the following.

- **Actual events** (eg employee turnover, salary increases) differ from the actuarial assumptions that were made to estimate the defined benefit obligations
- The effect of **changes to assumptions** concerning benefit payment options
- **Estimates are revised** (eg different assumptions are made about future employee turnover, salary rises, mortality rates, and so on)
- The effect of changes to the **discount rate**

Actuarial gains and losses are recognised in **other comprehensive income**. They are **not reclassified to profit or loss** under the 2011 revision to IAS 1 (see Chapter 23).

5.11.2 Return on plan assets

A new valuation of the plan assets is carried out at each period end, using current fair values. Any difference between the new value, and what has been recognised up to that date (normally the opening balance, interest, and any cash payments into or out of the plan) is treated as a 're-measurement' and recognised in other comprehensive income.

5.12 Example

At 1 January 20X2 the fair value of the assets of a defined benefit plan were valued at $1,100,000 and the present value of the defined benefit obligation was $1,250,000. On 31 December 20X2, the plan received contributions from the employer of $490,000 and paid out benefits of $190,000.

The current service cost for the year was $360,000 and a discount rate of 6% is to be applied to the net liability/(asset).

After these transactions, the fair value of the plan's assets at 31 December 20X2 was $1.5m. The present value of the defined benefit obligation was $1,553,600.

Required

Calculate the gains or losses on re-measurement through OCI and the return on plan assets and illustrate how this pension plan will be treated in the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X2.

Solution

It is always useful to set up a working reconciling the assets and obligation:

	Assets	*Obligation*
	$	$
Fair value/present value at 1/1/X2	1,100,000	1,250,000
Interest (1,100,000 × 6%)/(1,250,000 × 6%)	66,000	75,000
Current service cost		360,000
Contributions received	490,000	
Benefits paid	(190,000)	(190,000)
Return on plan assets excluding amounts in net interest (balancing figure) (OCI) (re-measurement)	34,000	-
Loss on re-measurement (balancing figure) (OCI)	-	58,600
	1,500,000	1,553,600

The following accounting treatment is required.

(a) In the **statement of profit or loss and other comprehensive income**, the following amounts will be recognised

In **profit or loss**:

	$
Current service cost	360,000
Net interest on net defined benefit liability (75,000 – 66,000)	9,000
In **other comprehensive income** (34,000 – 58,000)	24,000

(b) In the **statement of financial position**, the net defined benefit liability of $53,600 (1,553,6 00 – 1,500,000) will be recognised.

5.13 Section summary

The recognition and measurement of defined benefit plan costs are complex issues.

- Learn and understand the definitions of the various elements of a defined benefit pension plan
- Learn the **outline of the method of accounting** (see Paragraph 5.1)
- Learn the recognition method for the:
  - Statement of financial position
  - Statement of profit or loss and other comprehensive income

6 Defined benefit plans: other matters

We have now covered the basics of accounting for defined benefit plans. This section looks at the special circumstances of past service costs, curtailments and settlements.

6.1 Past service cost and gains and losses on settlement

FAST FORWARD

You should know how to deal with **past service costs and curtailments and settlements**.

In Paragraph 5.9 we identified that the total service cost may comprise not only the current service costs but other items, past service cost and gains and losses on settlement. This section explains these issues and their accounting treatment.

6.1.1 Past service cost

Past service cost is the change in the present value of the defined benefit obligation resulting from a plan **amendment** or **curtailment**.

A plan **amendment** arises when an entity either introduces a defined benefits plan or **changes the benefits payable** under an existing plan. As a result, the entity has taken on additional obligations that it has not hitherto provided for. For example, an employer might decide to introduce a medical benefits scheme for former employees. This will create a new defined benefit obligation, that has not yet been provided for.

A **curtailment occurs when an entity significantly reduces the number of employees covered by a plan**. This could result from an isolated event, such as closing a plant, discontinuing an operation or the termination or suspension of a plan.

Past service costs can be either **positive** (if the changes increase the obligation) or **negative** (if the change reduces the obligation).

6.1.2 Gains and losses on settlement

A **settlement** occurs either when an employer enters into a transaction to eliminate part or all of its post-employment benefit obligations (other than a payment of benefits to or on behalf of employees under the terms of the plan and included in the actuarial assumptions).

A curtailment and settlement might **happen together**, for example when an employer brings a defined benefit plan to an end by settling the obligation with a one-off lump sum payment and then scrapping the plan.

The gain or losses on a settlement is the difference between:

(a) The **present value of the defined benefit obligation** being settled, as valued on the date of the settlement; and

(b) The **settlement price**, including any plan assts transferred and any payments made by the entity directly in connection with the settlement.

6.1.3 Accounting for past service cost and gains and losses on settlement

An entity should **re-measure the obligation** (and the related plan assets, if any) using current actuarial assumptions, before determining past service cost or a gain or loss on settlement.

The rules for recognition for these items are as follows.

Past service costs are recognised at the earlier of the following dates:

(a) When the plan amendment or curtailment occurs, and

(b) When the entity recognises related restructuring costs (in accordance with IAS 37, see Chapter 9) or termination benefits.

6.2 Asset ceiling test

When we looked at the recognition of the net defined benefit liability/(asset) in the statement of financial position at the beginning of Section 5 the term 'asset ceiling' was mentioned. This term relates to a threshold established by IAS 19 to ensure that any defined benefit asset (ie a pension surplus) is carried at **no more than its recoverable amount**. In simple terms, this means that any net asset is restricted to the amount of cash savings that will be available to the entity in future.

6.3 Net defined benefit assets

A net defined benefit asset may arise if the plan has been overfunded or if actuarial gains have arisen. This meets the definition of an asset (as stated in the *Conceptual Framework*) because **all** of the following apply.

(a) The entity **controls a resource** (the ability to use the surplus to generate future benefits).

(b) That control is the **result of past events** (contributions paid by the entity and service rendered by the employee).

(c) **Future benefits** are available to the entity in the form of a reduction in future contributions or a cash refund, either directly or indirectly to another plan in deficit.

The **asset ceiling** is the **present value** of those future benefits. The **discount rate used is the same** as that used to calculate the net interest on the net defined benefit liability/(asset). The net defined benefit asset would be reduced to the asset ceiling threshold. Any related write down would be treated as a **re-measurement** and recognised in **other comprehensive income**.

If the asset ceiling adjustment was needed in a subsequent year, the changes in its value would be treated as follows:

(a) **Interest** (as it is a discounted amount) recognised in profit or loss as part of the net interest amount

(b) **Other changes** recognised in profit or loss.

6.4 Suggested approach and question

The suggested approach to defined benefit schemes is to deal with the change in the obligation and asset in the following order.

Step	Item	Recognition
1	**Record opening figures:** • Asset • Obligation	
2	**Interest cost on obligation** • Based on discount rate and PV obligation at start of period. • Should also reflect any changes in obligation during period.	DEBIT *Interest cost (P/L)* *($x\% \times$ b/d obligation)* CREDIT *PV defined benefit obligation (SOFP)*
3	**Interest on plan assets** • Based on discount rate and asset value at start of period. • Technically, this interest is also time apportioned on contributions less benefits paid in the period.	DEBIT *Plan assets (SOFP)* CREDIT *Interest cost (P/L)* *($x\% \times$ b/d assets)*
4	**Current service cost** • Increase in the present value of the obligation resulting from employee service in the current period.	DEBIT *Current service cost (P/L)* CREDIT *PV defined benefit obligation (SOFP)*
5	**Contributions** • As advised by actuary.	DEBIT *Plan assets (SOFP)* CREDIT *Company cash*
6	**Benefits** • Actual pension payments made.	DEBIT *PV defined benefit obligation (SOFP)* CREDIT *Plan assets (SOFP)*
7	**Past service cost** • Increase/decrease in PV obligation as a result of introduction or improvement of benefits.	**Positive (increase in obligation):** DEBIT *Past service cost (P/L)* CREDIT *PV defined benefit obligation (SOFP)* **Negative (decrease in obligation):** DEBIT *PV defined benefit obligation (SOFP)* CREDIT *Past service cost (P/L)*
8	**Gains and losses on settlement** • Difference between the value of the obligation being settled and the settlement price.	**Gain** DEBIT *PV defined benefit obligation (SOFP)* CREDIT *Service cost (P/L)* **Loss** DEBIT *Service cost (P/L)* CREDIT *PV defined benefit obligation (SOFP)*

Step	Item	Recognition
9	**Re-measurements: actuarial gains and losses** • Arising from annual valuations of obligation. • On obligation, differences between actuarial assumptions and actual experience during the period, or changes in actuarial assumptions.	**Gain** DEBIT *PV defined benefit obligation (SOFP)* CREDIT *Other comprehensive income* **Loss** DEBIT *Other comprehensive income* CREDIT *PV defined benefit obligation (SOFP)*
10	**Re-measurements: return on assets (excluding amounts in net-interest)** • Arising from annual valuations of plan assets	**Gain** DEBIT *FV plan assets (SOFP)* CREDIT *Other comprehensive income* **Loss** DEBIT *Other comprehensive income* CREDIT *FV plan assets (SOFP)*
11	**Disclose in accordance with the standard**	See comprehensive question.

Exam focus point

It would be useful for you to review your answers to questions on accounting for post-employment defined benefit schemes one last time. Questions on these are likely in the exam.

Question

Comprehensive

For the sake of simplicity and clarity, all transactions are assumed to occur at the year end.

The following data applies to the post employment defined benefit compensation scheme of BCD Co.
Discount rate: 10% (each year)
Present value of obligation at start of 20X2: $1m
Market value of plan assets at start of 20X2: $1m

The following figures are relevant.

	20X2	*20X3*	*20X4*
	$'000	$'000	$'000
Current service cost	140	150	150
Benefits paid out	120	140	150
Contributions paid by entity	110	120	120
Present value of obligation at year end	1,200	1,650	1,700
Fair value of plan assets at year end	1,250	1,450	1,610

Additional information:

(1) At the end of 20X3, a division of the company was sold. As a result of this, a large number of the employees of that division opted to transfer their accumulated pension entitlement to their new employer's plan. Assets with a fair value of $48,000 were transferred to the other company's plan and the actuary has calculated that the reduction in BCD's defined benefit liability is $50,000. The year end valuations in the table above were carried out **before** this transfer was recorded.

(2) At the end of 20X4, a decision was taken to make a one-off additional payment to former employees currently receiving pensions from the plan. This was announced to the former employees before the year end. This payment was not allowed for in the original terms of the scheme. The actuarial valuation of the obligation in the table above **includes** the additional liability of $40,000 relating to this additional payment.

Required

Show how the reporting entity should account for this defined benefit plan in each of years 20X2, 20X3 and 20X4.

Answer

The gain or loss on re-measurement (actuarial gain or loss) is established as a balancing figure in the calculations, as follows.

Present value of obligation

	20X2	*20X3*	*20X4*
	$'000	$'000	$'000
PV of obligation at start of year	1,000	1,200	1,600
Interest cost (10%)	100	120	160
Current service cost	140	150	150
Past service cost			40
Benefits paid	(120)	(140)	(150)
Settlements		(50)	
(Gain) or loss on remeasurement through OCIn: balancing figure	80	320	(100)
PV of obligation at end of year	1,200	1,600*	1,700

**(1,650 – 50)*

Market value of plan assets

	20X2	*20X3*	*20X4*
	$'000	$'000	$'000
Market value of plan assets at start of year	1,000	1,250	1,402
Interest on plan assets (10%)	100	125	140
Contributions	110	120	120
Benefits paid	(120)	(140)	(150)
Settlements	-	(48)	-
Gain on re-measurement through OCI: balancing figure	160	95	98
Market value of plan assets at year end	1,250	1,402*	1,610

**(1,450 – 48)*

In the statement of financial position, the liability that is recognised is calculated as follows.

	20X2	*20X3*	*20X4*
	$'000	$'000	$'000
Present value of obligation	1,200	1,600	1,700
Market value of plan assets	1,250	1,402	1,610
Liability/(asset) in statement of financial position	(50)	198	90

The following will be recognised in profit or loss for the year:

	20X2	*20X3*	*20X4*
	$'000	$'000	$'000
Current service cost	140	150	150
Past service cost	-	-	40
Net interest on defined benefit liability (asset)	-	(5)	20
Gain on settlement of defined benefit liability		2	
Expense recognised in profit or loss	140	147	210

The following re-measurements will be recognised in other comprehensive income for the year:

	20X2	*20X3*	*20X4*
	$'000	$'000	$'000
Actuarial (gain)/loss on obligation	80	320	(100)
Return on plan assets (excluding amounts in net-interest)	(160)	(95)	(98)

7 Other long term benefits

7.1 Definition

IAS 19 defines **other long-term employee benefits** as all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits if not expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

The types of benefits that might fall into this category include:

(a) Long-term paid absences such as long-service or sabbatical leave

(b) Jubilee or other long-service benefits

(c) Long-term disability benefits; profit-sharing and bonuses

(d) Deferred remuneration

7.2 Accounting treatment for other long-term benefits

There are many similarities between these types of benefits and defined benefit pensions. For example, in a long-term bonus scheme, the employees may provide service over a number of periods to earn their entitlement to a payment at a later date. In some case, the entity may put cash aside, or invest it in some way (perhaps by taking out an insurance policy) to meet the liabilities when they arise.

As there is normally far less uncertainty relating to the measurement of these benefits, IAS 19 requires a simpler method of accounting for them. Unlike the accounting method for post-employment benefits, this method does **not recognise re-measurements in other comprehensive income**.

The entity should recognise all of the following in **profit or loss**.

(a) **Service cost**

(b) **Net interest** on the defined benefit liability (asset)

(c) **Re-measurement** of the defined benefit liability (asset)

8 Disclosures

8.1 Principles of disclosures required by IAS 19

The outline requirements are for the entity to disclose information that:

(a) Explains the characteristics of its defined benefit plans and risks associated with them;

(b) Identifies and explains the amounts in its financial statements arising from its defined benefit plans; and

(c) Describes how its defined benefit plans may affect the amount, timing and uncertainty of the entity's future cash flows.

Chapter Roundup

- **IAS 19** ***Employee benefits*** is a long and complex standard covering both short-term and long-term (post-employment) benefits. The complications arise when dealing with **post-employment benefits**.
- The accounting for **short-term employee benefits** is simple. The principles are the same as for any expense that is accrued over a period.
- There are **two types of post-employment benefit plan**:
  - Defined contribution plans
  - Defined benefit plans
- Defined contribution plans are simple to account for as the benefits are defined by the contributions made.
- Defined benefit plans are much more difficult to deal with as the benefits are promised, they define the contributions to be made.
- There is a **four-step method** for recognising and measuring the expenses and liability of a defined benefit pension plan.
- You should know how to deal with **past service costs and curtailments and settlements**.

Quick Quiz

1. What are the four categories of employee benefits given by IAS 19?
2. What is the difference between defined contribution and defined benefit plans?
3. What is a 'constructive obligation' compared to a legal obligation?
4. How should a defined benefit expense be recognised in profit or loss for the year?
5. What causes actuarial gains or losses?

Answers to Quick Quiz

1
- Short-term
- Post-employment
- Other long-term
- Termination

2 See Paragraph 3.1.

3 A constructive obligation exists when the entity has no realistic alternative than to pay employee benefits.

4 Current service cost + interest + expected return + recognised actuarial gains/losses + past service cost + curtailments or settlements.

5 Gains or losses due to changes in actuarial assumptions.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q13	Introductory	n/a	n/a

11

Financial instruments

Topic list	Syllabus reference
1 Financial instruments	B7
2 Presentation of financial instruments	B7
3 Recognition of financial instruments	B7
4 Measurement of financial instruments	B7
5 Embedded derivatives	B7
6 Hedge Accounting	B7
7 Disclosure of financial instruments	B7
8 Fair value measurement	B7

Introduction

Financial instruments sounds like a daunting subject, and indeed this is a complex and controversial area. The numbers involved in financial instruments are often huge, but don't let this put you off. In this chapter we aim to simplify the topic as much as possible and to focus on the important issues.

IFRS 9, the most recent standard on financial instruments replaces IAS 39. It is a work in progress, and has not yet been updated for hedging and impairment, which are still at the ED stage.

Study guide

B7	**Financial Instruments**
(a)	Account for debt instruments, equity instruments and the allocation of finance costs
(b)	Account for fixed interest rate and convertible bonds
(c)	Discuss the definition and classification of a financial instrument
(d)	Discuss the measurement issues relating to financial instruments
(e)	Explain the current measurement proposals for financial instruments including the use of current values, hedging and the treatment of gains and losses
(f)	Describe the nature of the disclosures requirements relating to financial instruments
(g)	Discuss the key areas where consensus is required on the accounting treatment of financial instruments

Exam focus point

Although the complexity of this topic makes it likely to come up in an exam, there are limits as to how detailed a question the examiner can reasonably set. You should concentrate on the essential points. It is likely that it will be examined within a larger scenario based question, so be prepared for numerical calculations on financial instruments within questions on other topics.

1 Financial instruments

FAST FORWARD

Financial instruments can be very complex, particularly **derivative instruments**, although **primary instruments** are more straightforward.

1.1 Background

If you read the financial press you will probably be aware of **rapid international expansion** in the use of financial instruments. These vary from straightforward, traditional instruments, eg bonds, through to various forms of so-called 'derivative instruments'.

We can perhaps summarise the reasons why a project on the accounting for financial instruments was considered necessary as follows.

(a) The **significant growth of financial instruments** over recent years has outstripped the development of guidance for their accounting.

(b) The topic is of **international concern**, other national standard-setters are involved as well as the IASB.

(c) There have been recent **high-profile disasters** involving derivatives (eg Barings) which, while not caused by accounting failures, have raised questions about accounting and disclosure practices.

These are four accounting standards on financial instruments:

(a) IAS 32 *Financial instruments: Presentation*, which deals with:

   (i) The classification of financial instruments between liabilities and equity
   (ii) Presentation of certain compound instruments

(b) IFRS 7 *Financial instruments: Disclosures*, which revised, simplified and incorporated disclosure requirements previously in IAS 32.

(c) IAS 39 *Financial instruments: Recognition and measurement,* which dealt with:

   (i) Recognition and derecognition
   (ii) The measurement of financial instruments
   (iii) Hedge accounting

(d) IFRS 9 *Financial Instruments*, issued in November 2009, replaced parts of IAS 39, with respect to the classification and measurement of financial assets. In 2010, IFRS 9 was updated to include the classification and measurement of financial liabilities and the derecognition of financial assets and liabilities. This standard is a work in progress and in due course will be developed further to fully replace IAS 39. It will come into force for accounting periods ending in 2015. This is Phase 1 of the project to replace IAS 39.

(e) *Impairment Methodology.* An Exposure Draft *Financial Instruments: Amortised Cost and Impairment* was issued in November 2009, with a supplement in January 2011. This is Phase 2 of the project to replace IAS 39.

(f) *Hedge accounting.* This is Phase 3 of the project to replace IAS 39. An exposure draft was issued in December 2010.

1.2 Definitions

The most important definitions are common to all four standards.

FAST FORWARD

The important definitions to learn are:

- **Financial asset**
- **Financial liability**
- **Equity instrument**

Key terms

Financial instrument. Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset. Any asset that is:

(a) Cash
(b) An equity instrument of another entity
(c) A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity, or
(d) A contract that will or may be settled in the entity's own equity instruments and is:

   (i) A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
   (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Financial liability. Any liability that is:

(a) A contractual obligation:

   (i) To deliver cash or another financial asset to another entity, or
   (ii) To exchange financial instruments with another entity under conditions that are potentially unfavourable; or

(b) A contract that will or may be settled in the entity's own equity instruments and is:

   (i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
   (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Key terms (cont'd)

Equity instrument. Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Derivative. A financial instrument or other contract with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date. *(IAS 32, IFRS 9 and IFRS 13)*

Exam focus point

These definitions are very important, so make sure that you learn and understand them.

We should clarify some points arising from these definitions. First, one or two terms above should be themselves defined.

(a) A '**contract**' need not be in writing, but it must comprise an agreement that has 'clear economic consequences' and which the parties to it cannot avoid, usually because the agreement is enforceable in law.

(b) An '**entity**' here could be an individual, partnership, incorporated body or government agency.

The definitions of **financial assets and financial liabilities** may seem rather circular, referring as they do to the terms financial asset and financial instrument. The point is that there may be a chain of contractual rights and obligations, but it will lead ultimately to the receipt or payment of cash *or* the acquisition or issue of an equity instrument.

Examples of **financial assets** include:

(a) Trade receivables
(b) Options
(c) Shares (when used as an investment)

Examples of **financial liabilities** include:

(a) Trade payables
(b) Debenture loans payable
(c) Redeemable preference (non-equity) shares
(d) Forward contracts standing at a loss

As we have already noted, financial instruments include both of the following.

(a) **Primary instruments**: eg receivables, payables and equity securities

(b) **Derivative instruments**: eg financial options, futures and forwards, interest rate swaps and currency swaps, **whether recognised or unrecognised**

IAS 32 makes it clear that the following items are *not* financial instruments.

(a) **Physical assets**, eg inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc)

(b) **Prepaid expenses**, deferred revenue and most warranty obligations

(c) Liabilities or assets that are **not contractual** in nature

(d) Contractual rights/obligations that **do not involve transfer of a financial asset**, eg commodity futures contracts, operating leases

Question

Why not?

Can you give the reasons why the first two items listed above do not qualify as financial instruments?

Answer

Refer to the definitions of financial assets and liabilities given above.

(a) **Physical assets**: control of these creates an opportunity to generate an inflow of cash or other assets, but it does not give rise to a present right to receive cash or other financial assets.

(b) **Prepaid expenses, etc**: the future economic benefit is the receipt of goods/services rather than the right to receive cash or other financial assets.

(c) **Deferred revenue, warranty obligations**: the probable outflow of economic benefits is the delivery of goods/services rather than cash or another financial asset.

Contingent rights and obligations meet the definition of financial assets and financial liabilities respectively, even though many do not qualify for recognition in financial statements. This is because the contractual rights or obligations exist because of a past transaction or event (eg assumption of a guarantee).

1.3 Derivatives

A **derivative** is a financial instrument that **derives** its value from the price or rate of an underlying item. Common **examples** of derivatives include:

(a) **Forward contracts**: agreements to buy or sell an asset at a fixed price at a fixed future date

(b) **Futures contracts**: similar to forward contracts except that contracts are standardised and traded on an exchange

(c) **Options**: rights (but not obligations) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised

(d) **Swaps**: agreements to swap one set of cash flows for another (normally interest rate or currency swaps).

The nature of derivatives often gives rise to **particular problems**. The **value** of a derivative (and the amount at which it is eventually settled) depends on **movements** in an underlying item (such as an exchange rate). This means that settlement of a derivative can lead to a very different result from the one originally envisaged. A company which has derivatives is exposed to **uncertainty and risk** (potential for gain or loss) and this can have a very material effect on its financial performance, financial position and cash flows.

Yet because a derivative contract normally has **little or no initial cost**, under traditional accounting it **may not be recognised** in the financial statements at all. Alternatively, it may be recognised at an amount which bears no relation to its current value. This is clearly **misleading** and leaves users of the financial statements unaware of the **level of risk** that the company faces. IASs 32 and 39 were developed in order to correct this situation.

1.4 Section summary

- Four accounting standards are relevant:
  - **IFRS 9** *Financial instruments* (a 'work-in-progress', now covering classification, measurement, recognition and derecognition of financial assets and liabilities)
  - **IAS 32**: *Financial instruments: Presentation*
  - **IFRS 7**: *Financial instruments: Disclosures*

– **IAS 39**: *Financial instruments: Recognition and measurement* (to be replaced, still applicable to hedging and impairment)

- The definitions of **financial asset, financial liability** and **equity instrument** are fundamental to the standards.
- Financial instruments include:
  – **Primary** instruments
  – **Derivative** instruments

2 Presentation of financial instruments

2.1 Objective

The objective of IAS 32 is:

'to enhance financial statement users' understanding of the significance of on-balance-sheet and off-balance-sheet financial instruments to an entity's financial position, performance and cash flows.'

2.2 Scope

IAS 32 should be applied in the presentation of **all types of financial instruments**, whether recognised or unrecognised.

Certain items are **excluded**.

- Interests in subsidiaries (IAS 27: Chapter 21)
- Interests in associates (IAS 28: Chapter 24)
- Interests in joint arrangements (IFRS 11: Chapter 25)
- Pensions and other post-retirement benefits (IAS 19: Chapter 10)
- Insurance contracts
- Contracts for contingent consideration in a business combination
- Contracts that require a payment based on climatic, geological or other physical variables
- Financial instruments, contracts and obligations under share-based payment transactions (IFRS 2: Chapter 15)

2.3 Liabilities and equity

FAST FORWARD

Financial instruments must be classified as **liabilities** or **equity** according to their **substance**.

The critical feature of a financial liability is the **contractual obligation to deliver cash** or another financial asset.

The main thrust of IAS 32 here is that financial instruments should be presented according to their **substance**, **not merely their legal form**. In particular, entities which issue financial instruments should classify them (or their component parts) as **either financial liabilities, or equity**.

The classification of a financial instrument as a liability or as equity depends on the following.

- The substance of the contractual arrangement on initial recognition
- The definitions of a financial liability and an equity instrument

How should a **financial liability be distinguished from an equity instrument**? The critical feature of a **liability** is an **obligation** to transfer economic benefit. Therefore, a financial instrument is a financial liability if there is a **contractual obligation** on the issuer either to deliver cash or another financial asset to the holder or to exchange another financial instrument with the holder under potentially unfavourable conditions to the issuer.

The financial liability exists **regardless of the way in which the contractual obligation will be settled**. The issuer's ability to satisfy an obligation may be restricted, eg by lack of access to foreign currency, but this is irrelevant as it does not remove the issuer's obligation or the holder's right under the instrument.

Where the above critical feature is *not* met, then the financial instrument is an **equity instrument**. IAS 32 explains that although the holder of an equity instrument may be entitled to a *pro rata* share of any distributions out of equity, the issuer does *not* have a contractual obligation to make such a distribution.

Although substance and legal form are often **consistent with each other**, this is not always the case. In particular, a financial instrument may have the legal form of equity, but in substance it is in fact a liability. Other instruments may combine features of both equity instruments and financial liabilities.

For example, many entities issue **preferred shares** which must be **redeemed** by the issuer for a fixed (or determinable) amount at a fixed (or determinable) future date. Alternatively, the holder may have the right to require the issuer to redeem the shares at or after a certain date for a fixed amount. In such cases, the issuer has an **obligation**. Therefore the instrument is a **financial liability** and should be classified as such.

The classification of the financial instrument is made when it is **first recognised** and this classification will continue until the financial instrument is removed from the entity's statement of financial position.

2.4 Contingent settlement provisions

An entity may issue a financial instrument where the way in which it is settled depends on:

(a) The occurrence or non-occurrence of uncertain future events, or
(b) The outcome of uncertain circumstances,

that are beyond the control of both the holder and the issuer of the instrument. For example, an entity might have to deliver cash instead of issuing equity shares. In this situation it is not immediately clear whether the entity has an equity instrument or a financial liability.

Such financial instruments should be classified as **financial liabilities** unless the possibility of settlement is remote.

2.5 Settlement options

When a derivative financial instrument gives one party a **choice** over how it is settled (eg, the issuer can choose whether to settle in cash or by issuing shares) the instrument is a **financial asset** or a **financial liability** unless **all the alternative choices** would result in it being an equity instrument.

2.6 Compound financial instruments

FAST FORWARD

Compound instruments are split into **equity** and **liability** components and presented accordingly in the statement of financial position.

Some financial instruments contain both a liability and an equity element. In such cases, IAS 32 requires the component parts of the instrument to be **classified separately**, according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

One of the most common types of compound instrument is **convertible debt**. This creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument (usually ordinary shares) of the issuer. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

Although in theory there are several possible ways of calculating the split, the following method is recommended:

(a) Calculate the value for the liability component.
(b) Deduct this from the instrument as a whole to leave a residual value for the equity component.

The reasoning behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities.

The **sum of the carrying amounts** assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument **as a whole**.

2.7 Example: Valuation of compound instruments

Rathbone Co issues 2,000 convertible bonds at the start of 20X2. The bonds have a three-year term, and are issued at par with a face value of $1,000 per bond, giving total proceeds of $2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common share is $3. The dividends expected over the three-year term of the bonds amount to 14c per share at the end of each year. The risk-free annual interest rate for a three-year term is 5%.

Required

What is the value of the equity component in the bond?

Solution

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

	$
Present value of the principal: $2,000,000 payable at the end of three years	
($2m × 0.772)*	1,544,000
Present value of the interest: $120,000 payable annually in arrears for three years	
($120,000 × 2.531)*	303,720
Total liability component	1,847,720
Equity component (balancing figure)	152,280
Proceeds of the bond issue	2,000,000

* These figures can be obtained from discount ($(1+r)^{-n}$) and annuity $\left(\frac{1-(1+r)^{-n}}{r}\right)$ formulae.

The split between the liability and equity components remains the same throughout the term of the instrument, even if there are changes in the **likelihood of the option being exercised**. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payments until conversion, maturity of the instrument or some other relevant transaction takes place.

2.8 Treasury shares

If an entity **reacquires its own equity instruments**, those instruments ('treasury shares') shall be **deducted from equity**. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid or received shall be recognised directly in equity.

2.9 Interest, dividends, losses and gains

As well as looking at statement of financial position presentation, IAS 32 considers how financial instruments affect the profit or loss (and movements in equity). The treatment varies according to whether interest, dividends, losses or gains relate to a financial liability or an equity instrument.

(a) Interest, dividends, losses and gains relating to a financial instrument (or component part) classified as a **financial liability** should be recognised as **income or expense** in profit or loss.

(b) Distributions to holders of a financial instrument classified as an **equity instrument** should be **debited directly to equity** by the issuer.

(c) **Transaction costs** of an equity transaction shall be accounted for as a **deduction from equity** (unless they are directly attributable to the acquisition of a business, in which case they are accounted for under IFRS 3).

You should look at the requirements of IAS 1 *Presentation of financial statements* for further details of disclosure, and IAS 12 *Income taxes* for disclosure of tax effects.

2.10 Offsetting a financial asset and a financial liability

A financial asset and financial liability should **only** be **offset**, with the net amount reported in the statement of financial position, when an entity:

(a) Has a legally enforceable right of set off, *and*

(b) Intends to settle on a net basis, or to realise the asset and settle the liability simultaneously, ie at the same moment.

This will reflect the expected **future cash flows** of the entity in these specific circumstances. In all other cases, financial assets and financial liabilities are presented separately.

2.11 Amendment to IAS 32: Puttable financial instruments and obligations arising on liquidation

This amendment was issued in February 2008. The changes deal with puttable financial instruments and the effect obligations that arise on liquidation have on determining whether an instrument is debt or equity.

IAS 32 requires that if the holder of a financial instrument can require the issuer to redeem it for cash it should be classified as a liability. Some ordinary shares and partnership interests allow the holder to 'put' the instrument (that is to require the issuer to redeem it in cash). Such shares might more usually be considered as equity, but application of IAS 32 results in their being classified as liabilities.

The amendment requires entities to classify such instruments as equity, so long as they meet certain conditions. The amendment further requires that instruments imposing an obligation on an entity to deliver to another party a pro rata share of the net assets only on liquidation should be classified as equity.

2.12 Section summary

- Financial instruments issued to raise capital must be classified as **liabilities** or **equity**
- The **substance** of the financial instrument is more important than its **legal form**
- The **critical feature of a financial liability** is the contractual obligation to deliver cash or another financial instrument
- **Compound instruments** are split into equity and liability parts and presented accordingly
- **Interest, dividends, losses and gains** are treated according to whether they relate to an equity instrument or a financial liability

Exam focus point

There is a useful article on this subject in S*tudent Accountant*, entitled 'When does debt seem to be equity?'. It is available online at:

http://www.accaglobal.com/uk/en/student/acca-qual-student-journey/qual-resource/acca-qualification/p2/technical-articles/when-does-debt-seem-to-be-equity-.html

3 Recognition of financial instruments

FAST FORWARD

IFRS 9 *Financial Instruments*, issued in November 2009 and updated in October 2010 **replaced parts of IAS 39, with respect to the recognition, derecognition, classification and measurement of financial assets and liabilities**. In general, the rules were simplified. This standard is a work in progress and will fully replace IAS 39.

IFRS 9 *Financial instruments* establishes principles for recognising and measuring financial assets and financial liabilities.

3.1 Scope

IFRS 9 applies to **all entities** and to **all types of financial instruments except** those specifically excluded, as listed below.

(a) Investments in **subsidiaries, associates, and joint ventures** that are accounted for under IFRSs 10, 11 and 12
(b) **Leases** covered in IAS 17
(c) **Employee benefit plans** covered in IAS 19
(d) **Insurance contracts**
(e) **Equity instruments issued by the entity** eg ordinary shares issued, or options and warrants
(f) **Financial guarantee** contracts
(g) **Contracts for contingent consideration** in a business combination, covered in IFRS 3
(h) Contracts requiring payment based on climatic, geological or other **physical variables**
(i) **Loan commitments** that cannot be settled net in cash or another financial instrument
(j) Financial instruments, contracts and obligations under **share based payment transactions**, covered in IFRS 2.

3.2 Initial recognition

Financial instruments should be recognised in the statement of financial position when the entity becomes a party to the **contractual provisions of the instrument**.

Point to note

An important consequence of this is that all derivatives should be in the statement of financial position.

Notice that this is **different** from the recognition criteria in the *Conceptual Framework* and in most other standards. Items are normally recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

3.3 Example: initial recognition

An entity has entered into two separate contracts.

(a) A firm commitment (an order) to buy a specific quantity of iron.
(b) A forward contract to buy a specific quantity of iron at a specified price on a specified date, provided delivery of the iron is not taken.

Contract (a) is a **normal trading contract**. The entity does not recognise a liability for the iron until the goods have actually been delivered. (Note that this contract is not a financial instrument because it involves a physical asset, rather than a financial asset.)

Contract (b) is a **financial instrument**. Under IFRS 9, the entity recognises a financial liability (an obligation to deliver cash) on the **commitment date**, rather than waiting for the closing date on which the exchange takes place.

Note that planned future transactions, no matter how likely, are not assets and liabilities of an entity – the entity has not yet become a party to the contract.

3.4 Derecognition of financial assets 6/12

Derecognition is the removal of a previously recognised financial instrument from an entity's statement of financial position. An entity should derecognise a **financial asset** when:

(a) The **contractual rights** to the cash flows from the financial asset **expire**, or

(b) The entity **transfers the financial asset or substantially all the risks and rewards of ownership** of the financial asset to another party.

IFRS 9 gives **examples of where an entity has transferred substantially all the risks and rewards of ownership**. These include:

(a) An unconditional sale of a financial asset

(b) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase.

The standard also **provides examples of situations where the risks and rewards of ownership have not been transferred**:

(a) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return

(b) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity

(c) A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

It is possible for only **part** of a financial asset or liability to be derecognised. This is allowed if the part comprises:

(a) Only specifically identified cash flows; or
(b) Only a fully proportionate (pro rata) share of the total cash flows.

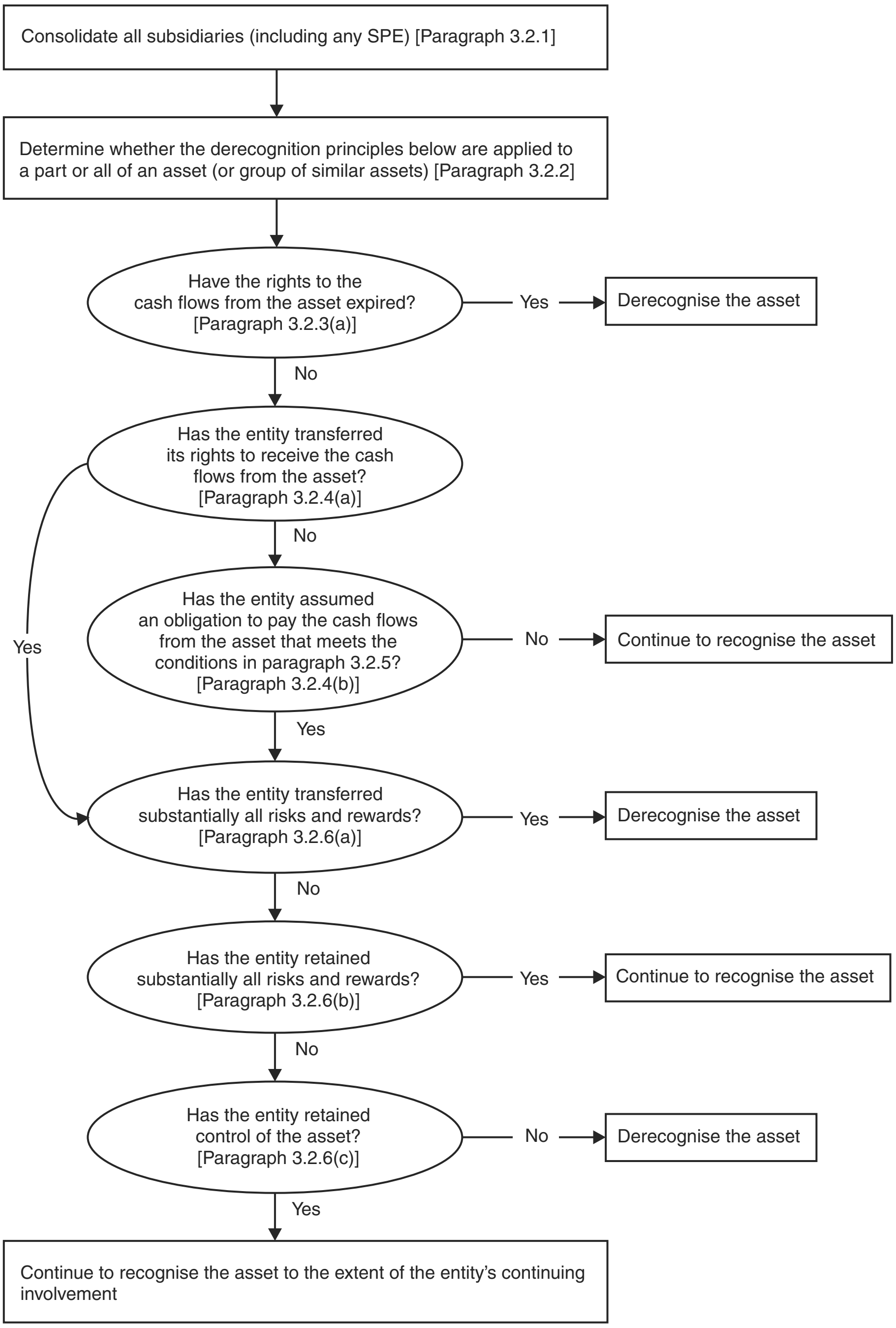
For example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

On derecognition, the amount to be included in net profit or loss for the period is calculated as follows.

Formula to learn

	$	$
Carrying amount (measured at the date of derecognition) allocated to the part derecognised		X
Less: consideration received for the part derecognised (including any new asset obtained less any new liability assumed)	X	(X)
Difference to profit or loss		X

The following flowchart, taken from the appendix to the standard, will help you decide whether, and to what extent, a financial asset is derecognised.



Source: IFRS 9

3.5 Derecognition of financial liabilities

A financial liability is derecognised **when it is extinguished** – ie when the obligation specified in the contract is discharged or cancelled or expires.

(a) Where an existing borrower and lender of debt instruments exchange one financial instrument for another with substantially different terms, this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

(b) Similarly, a substantial modification of the terms of an existing financial liability or a part of it should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

(c) For this purpose, a modification is 'substantial' where the discounted present value of cash flows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the cash flows of the original financial liability.

(d) The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

3.6 Classification of financial assets

On **recognition,** IFRS 9 requires that financial assets are **classified as measured** at either:

- **Amortised cost**, or
- **Fair value**

3.6.1 Comparison table

The following table shows the extent to which IFRS 9 simplifies the IAS 39 definitions.

Old IAS 39 Category	Measured at	Gains and losses
Financial asset at fair value through profit or loss	Fair value	Profit or loss
Available for sale financial asset	Fair value	Other comprehensive income
Financial asset held to maturity	Amortised cost	Profit or loss
Loans and receivables	Amortised cost	Profit or loss

The IFRS 9 classification is made on the basis of both:

(a) The **entity's business model** for managing the financial assets, and
(b) The **contractual cash flow** characteristics of the financial asset.

A financial asset is classified as measured at amortised cost where:

(a) The objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows and

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

An application of these rules means that **equity investments may not be classified as measured at amortised cost** and must be measured at fair value. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. In addition, **all derivatives are measured at fair value**.

A **debt instrument** may be classified as measured at either amortised cost or fair value **depending on whether it meets the criteria above**. Even where the criteria are met at initial recognition, a debt instrument may be classified as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

3.6.2 Business model test in more detail

IFRS 9 introduces a business model test that requires an entity to assess whether its **business objective for a debt instrument is to collect the contractual cash flows of the instrument as opposed to realising its fair value change from sale prior to its contractual maturity**. Note the following key points:

(a) The assessment of a 'business model' is not made at an individual financial instrument level.

(b) The assessment is based on how key management personnel actually manage the business, rather than management's intentions for specific financial assets.

(c) An entity may have more than one business model for managing its financial assets and the classification need not be determined at the reporting entity level. For example, it may have one portfolio of investments that it manages with the objective of collecting contractual cash flows and another portfolio of investments held with the objective of trading to realise changes in fair value. It would be appropriate for entities like these to carry out the assessment for classification purposes at portfolio level, rather than at entity level.

(d) Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur.

3.6.3 Business model test: examples

The following examples, from the Application Guidance to IFRS 9, are of situations where the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows.

Example 1

An entity holds investments to collect their contractual cash flows but would sell an investment in particular circumstances, perhaps to fund capital expenditure, or because the credit rating of the instrument falls below that required by the entity's investment policy.

Analysis

Although an entity may consider, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective. If sales became frequent, the entity might be required to reconsider whether the sales were consistent with an objective of collecting contractual cash flows.

Example 2

An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.

The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors in the vehicle.

It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.

Analysis

The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows.

However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.

Example 3

An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets with incurred credit losses. If payment on the loans is not made on a timely basis, the entity attempts to extract the contractual cash flows through various means – for example, by contacting the debtor through mail, telephone, and so on.

In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

Analysis

The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio to make a profit by selling them.

The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets have incurred credit losses).

Moreover, the fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model. If the portfolio is not managed on a fair value basis, the objective of the business model could be to hold the assets to collect the contractual cash flows.

3.6.4 Contractual cash flow test in more detail

The requirement in IFRS 9 to assess the contractual cash flow characteristics of a financial asset is based on the concept that **only instruments with contractual cash flows of principal and interest on principal may qualify for amortised cost measurement**. By interest, IFRS 9 means consideration for the time value of money and the credit risk associated with the principal outstanding during a particular period of time.

Question — **Contractual cash flows**

Would an investment in a convertible loan qualify to be measured at amortised cost under IFRS 9?

Answer

No, because of the inclusion of the conversion option which is not deemed to represent payments of principal and interest

Measurement at amortised cost is permitted when the cash flows on a loan are entirely fixed (eg a fixed interest rate loan or zero coupon bond), or where interest is floating (eg a GBP loan where interest is contractually linked to GBP LIBOR), or combination of fixed and floating (eg where interest is LIBOR plus a fixed spread).

3.6.5 Examples of instruments that pass the contractual cash flows test

The following instruments satisfy the IFRS 9 criteria.

(a) A variable rate instrument with a stated maturity date that permits the borrower to choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term

(b) A fixed term variable market interest rate bond where the variable interest rate is capped

(c) A fixed term bond where the payments of principal and interest are linked to an unleveraged inflation index of the currency in which the instrument is issued

3.6.6 Examples of instruments that do not pass the contractual cash flows test

The following instruments do not satisfy the IFRS 9 criteria.

(a) A bond that is convertible into equity instruments of the issuer (see question above)
(b) A loan that pays an inverse floating interest rate (eg 8% minus LIBOR)

Note that the IFRS 9 requirement to classify financial assets on recognition as one of two types is **a significant simplification** of the previous IAS 39 rules. These required financial assets to be classified as one of four types, being:

- At fair value through profit or loss
- Held to maturity
- Available for sale, and
- Loans and receivables.

3.7 Classification of financial liabilities

On **recognition**, IFRS 9 requires that financial assets are **classified as measured** at either:

(a) At **fair value through profit or loss**, or

(b) Financial liabilities at **amortised cost**.

A financial liability is classified at fair value through profit or loss if:

(a) It is **held for trading**, or

(b) Upon initial recognition it is **designated at fair value through profit or loss**.

Derivatives are always measured at fair value through profit or loss.

These classification rules are unchanged from those previously contained within IAS 39.

3.8 Re-classification of financial assets

Although on initial recognition financial instruments must be classified in accordance with the requirements of IFRS 9, in some cases they may be subsequently reclassified. IFRS 9 requires that **when an entity changes its business model for managing financial assets, it should reclassify all affected financial assets.** This reclassification applies only to debt instruments, as equity instruments must be classified as measured at fair value.

The application guidance to IFRS 9 includes examples of circumstances when a reclassification is required or is not permitted.

3.8.1 Examples: Reclassification permitted

Reclassification is permitted in the following circumstances, because a **change in the business model** has taken place:

(a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

(b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

3.8.2 Examples: Reclassification not permitted

Reclassification is **not permitted** in the following circumstances, because a **change in the business model has not taken place**.

(a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions)

(b) A temporary disappearance of a particular market for financial assets

(c) A transfer of financial assets between parts of the entity with different business models.

Reclassification of financial liabilities is not permitted.

3.9 Section summary

- **All financial assets** and **liabilities** should be **recognised in the statement of financial position**, including derivatives.
- Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire** or where **substantially all the risks and rewards of ownership are transferred** to another party.
- Financial liabilities should be derecognised when they are **extinguished**.

4 Measurement of financial instruments

FAST FORWARD

Financial assets should initially be measured at **cost** = **fair value**.

Transaction costs increase this amount for financial assets classified as measured at amortised cost, or where an irrevocable election has been made to take all gains and losses through other comprehensive income and **decrease this amount for financial liabilities** classified as measured at amortised cost.

Subsequent measurement of both financial assets and financial liabilities depends on how the instrument is classified: at amortised cost or fair value.

4.1 Initial measurement: financial assets

Financial instruments are initially measured at the transaction price, that is the **fair value** of the consideration given.

An **exception** is where part of the consideration given is for something other than the financial asset. In this case the financial asset is initially measured at fair value. The fair value is evidenced by a quoted price in an active market for an identical asset (ie an IFRS 13 level 1 input) or is based on a valuation technique that uses only data from observable markets. The difference between the fair value at initial recognition and the transaction price is recognised as a gain or loss.

In the case of financial assets classified as measured at **amortised cost**, **transaction costs** directly attributable to the acquisition of the financial asset are **added** to this amount.

4.2 Initial measurement: financial liabilities

IFRS 9 requires that financial liabilities are initially measured at transaction price, ie the fair value of consideration received except where part of the consideration received is for something other than the financial liability. In this case the financial liability is initially measured at fair value measured as for financial assets (see above). Transaction costs are deducted from this amount for financial liabilities classified as measured at amortised cost.

4.3 Subsequent measurement of financial assets

Under IFRS 9, financial assets are measured subsequent to recognition either at:

- At **amortised cost,** using the **effective interest method**, or
- At **fair value**

4.4 Financial assets measured at amortised cost

Key terms

Amortised cost of a financial asset or financial liability is the amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation of any difference between that initial amount and the maturity amount, and minus any write-down (directly or through the use of an allowance account) for impairment or uncollectability.

The **effective interest method** is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period.

The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability. (*IFRS 9*)

Exam focus point

> In the exam if a question required use of the amortised cost measurement method, the effective interest rate would be given.

4.5 Example: Financial asset at amortised cost

On 1 January 20X1 Abacus Co purchases a debt instrument for its fair value of \$1,000. The debt instrument is due to mature on 31 December 20X5. The instrument has a principal amount of \$1,250 and the instrument carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

How should Abacus Co account for the debt instrument over its five year term?

Solution

Abacus Co will receive interest of \$59 (1,250 × 4.72%) each year and \$1,250 when the instrument matures.

Abacus must allocate the discount of \$250 and the interest receivable over the five year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years:

Year	*Amortised cost at beginning of year*	*Profit or loss: Interest income for year (@10%)*	*Interest received during year (cash inflow)*	*Amortised cost at end of year*
	\$	\$	\$	\$
20X1	1,000	100	(59)	1,041
20X2	1,041	104	(59)	1,086
20X3	1,086	109	(59)	1,136
20X4	1,136	113	(59)	1,190
20X5	1,190	119	(1,250 + 59)	–

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year.

Investments whose **fair value cannot be reliably measured** should be measured at **cost**.

4.6 Financial assets measured at fair value

Where a financial asset is classified as measured at fair value, fair value is established at each period end in accordance with IFRS 13 *Fair value measurement.* That standard requires that a fair value hierarchy is applied with three levels of input:

Level 1 inputs. Unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.

Level 2 inputs. Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. These may include quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets and liabilities in markets that are not active.

Level 3 inputs. Unobservable inputs for the asset or liability.

Any changes in fair value are normally recognised in profit or loss.

There are two **exceptions** to this rule:

(a) The asset is **part of a hedging relationship** (see Section 6)

(b) The financial asset is an investment in an **equity instrument not held for trading**. In this case the entity can make an **irrevocable election** to recognise changes in the fair value in **other comprehensive income**.

Note that direct costs of acquisition are capitalised only in the case of a financial asset or financial liability **not** held at fair value through profit or loss If the asset or liability is held at fair value through profit or loss, the costs of acquisition are expensed. This means that in the in the case of **financial assets held at amortised cost, costs of acquisition are capitalised.** They would be added to the asset and deducted from the liability amount. Similarly, if an **irrevocable election** has been made to take **gains and losses** on the financial asset **to other comprehensive income,** costs of acquisition should be **added to the purchase cost.**

4.7 Example: Asset measurement

On 8 February 20X8 Orange Co acquires a quoted investment in the shares of Lemon Co with the intention of holding it in the long term. The investment cost $850,000. At Orange Co's year end of 31 March 20X8, the market price of an identical investment is $900,000. How is the asset initially and subsequently measured?

Orange Co has elected to recognise changes in the fair value of the equity investment in other comprehensive income.

Solution

- The asset is initially recognised at the fair value of the consideration, being $850,000
- At the period end it is re-measured to $900,000
- This results in the recognition of $50,000 in other comprehensive income

Question

Equity instrument and transaction costs

In January 20X6 Wolf purchased 10 million $1 listed equity shares in Hall at a price of $5 per share. Transaction costs were $3m. Wolf's year end is 30 November.

At 30 November 20X6, the shares in Hall were trading at $6.50. On 31 October 20X6 Wolf received a dividend of from Hall of 20c per share.

Show the financial statement extracts of Wolf at 30 November 20X6 relating to the investment in Hall on the basis that:

(i) The shares were bought for trading

(ii) The shares were bought as a source of dividend income and were the subject of an irrevocable election at initial recognition to recognise them at fair value through other comprehensive income.

Answer

(i)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	$m
Profit or loss for the year	
Investment income (10m × (6.5 – 5.0))	15
Dividend income (10m × 20c)	2
Transaction costs	(3)

STATEMENT OF FINANCIAL POSITION (EXTRACT)

Investments in equity instruments (10m × 6.5)	65

(ii)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME(EXTRACT)

	$m
Profit or loss for the year	
Dividend income	2
Other comprehensive income	
Gain on investment in equity instruments	15

STATEMENT OF FINANCIAL POSITION (EXTRACT)

Investments in equity instruments ((10m × 6.5) + 3m)	68

4.7.1 Subsequent measurement of financial liabilities

After initial recognition, all financial liabilities should be measured at **amortised cost**, with the exception of financial liabilities at fair value through profit or loss (including most derivatives). These should be measured at **fair value**, but where the fair value **is not capable of reliable measurement**, they should be measured at **cost**. (See Section 4.10 for more detail)

4.8 Financial liabilities measured at amortised cost

The definitions of amortised cost, effective interest method and effective interest rate that are used for measurement of financial assets are also used for financial liabilities.

4.9 Example: Financial liability at amortised cost

Galaxy Co issues a bond for $503,778 on 1 January 20X2. No interest is payable on the bond, but it will be redeemed on 31 December 20X4 for $600,000. The effective interest rate of the bond is 6%.

Required

Calculate the charge to profit or loss of Galaxy Co for the year ended 31 December 20X2 and the balance outstanding at 31 December 20X2.

Solution

The bond is a 'deep discount' bond and is a financial liability of Galaxy Co. It is measured at amortised cost. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

The effective interest rate is 6%.

The charge to profit or loss for the year is $30,226 (503,778 × 6%)

The balance outstanding at 31 December 20X2 is $534,004 (503,778 + 30,226)

Question **Finance cost 1**

On 1 January 20X3 Deferred issued $600,000 loan notes. Issue costs were $200. The loan notes do not carry interest, but are redeemable at a premium of $152,389 on 31 December 20X4. The effective finance cost of the debentures is 12%.

What is the finance cost in respect of the loan notes for the year ended 31 December 20X4?

A $72,000
B $76,194
C $80,613
D $80,640

Answer

C The premium on redemption of the preferred shares represents a finance cost. The effective rate of interest must be applied so that the debt is measured at amortised cost.

At the time of issue, the loan notes are recognised at their net proceeds of $599,800 (600,000 – 200).

The finance cost for the year ended 31 December 20X4 is calculated as follows:

	B/f	*Interest @ 12%*	*C/f*
	$	$	$
20X3	599,800	71,976	671,776
20X4	671,776	80,613	752,389

Question

Finance cost 2

On 1 January 20X5, an entity issued a debt instrument with a coupon rate of 3.5% at a par value of $6,000,000. The directly attributable costs of issue were $120,000. The debt instrument is repayable on 31 December 2011 at a premium of $1,100,000.

What is the total amount of the finance cost associated with the debt instrument?

A $1,470,000
B $1,590,000
C $2,570,000
D $2,690,000

Answer

D

	$
Issue costs	120,000
Interest $6,000,000 × 3.5% × 7	1,470,000
Premium on redemption	1,100,000
Total finance cost	2,690,000

Question

Classification

During the financial year ended 28 February 20X5, MN issued the two financial instruments described below. For *each* of the instruments, identify whether it should be classified as debt or equity, **explaining in not more than 40 words each** the reason for your choice. In each case you should refer to the relevant International Accounting Standard or International Financial Reporting Standard.

(i) Redeemable preferred shares with a coupon rate 8%. The shares are redeemable on 28 February 20X9 at premium of 10%.

(ii) A grant of share options to senior executives. The options may be exercised from 28 February 20X8.

Answer

(i) **Debt.** The preference shares require regular distributions to the holders but more importantly have the debt characteristic of being redeemable. Therefore, according to IAS 32 *Financial instruments: Presentation* they must be classified as debt.

(ii) **Equity.** According to IFRS 2 *Share based payment* the grant of share options must be recorded as equity in the statement of financial position. It is an alternative method of payment to cash for the provision of the services of the directors.

Question

Hybrid financial instrument

On 1 January 20X1, EFG issued 10,000 5% convertible bonds at their par value of $50 each. The bonds will be redeemed on 1 January 20X6. Each bond is convertible at the option of the holder at any time during the five-year period. Interest on the bond will be paid annually in arrears.

The prevailing market interest rate for similar debt without conversion options at the date of issue was 6%.

At what value should the equity element of the hybrid financial instrument be recognised in the financial statements of EFG at the date of issue?

Answer

Top tip. The method to use here is to find the present value of the principal value of the bond, $500,000 (10,000 × $50) and the interest payments of $25,000 annually (5% × $500,000) at the market rate for non-convertible bonds of 6%, using the discount factor tables. The difference between this total and the principal amount of $500,000 is the equity element.

	$
Present value of principal $500,000 × 0.747	373,500
Present value of interest $25,000 × 4.212	105,300
Liability value	478,800
Principal amount	500,000
Equity element	21,200

Question

Subsequent measurement

After initial recognition, all financial liabilities should be measured at amortised cost.

True ☐ False ☐

Answer

False. Some may be measured at fair value through profit or loss.

4.10 Financial liabilities at fair value through profit or loss

Financial liabilities which are held for trading are re-measured to fair value each year in accordance with IFRS 13 *Fair value measurement* (see Section 4.6) with any gain or loss recognised in profit or loss.

4.10.1 Exceptions

The exceptions to the above treatment of financial liabilities are:

(a) It is part of a hedging arrangement (see Section 6)

(b) It is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's **credit risk** in other comprehensive income (see 4.10. 2 below).

4.10.2 Credit risk

IFRS 9 requires that financial liabilities which are **designated as measured at fair value through profit or loss are treated differently**. In this case the gain or loss in a period must be classified into:

- Gain or loss **resulting from credit risk**, and
- **Othe**r gain or loss.

This change to IFRS 9 was made in 2010 in response to an anomaly regarding changes in the credit risk of a financial liability.

Changes in a financial liability's credit risk affect the fair value of that financial liability. This means that when an entity's creditworthiness deteriorates, the fair value of its issued debt will decrease (and *vice versa*). For financial liabilities measured using the fair value option, this causes **a gain (or loss) to be recognised in profit or loss for the year**. For example:

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)
PROFIT OR LOSS FOR THE YEAR

Liabilities at fair value (except derivatives and liabilities held for trading)	$'000
Change in fair value	100
Profit (loss) for the year	100

Many users of financial statements found this result to be **counter-intuitive** and confusing. Accordingly, IFRS 9 requires the gain or loss as a result of credit risk to be recognised in other comprehensive income, unless it creates or enlarges an **accounting mismatch** (see 4.10.4), in which case it is recognised in profit or loss. The other gain or loss (not the result of credit risk) is recognised in profit or loss.

On derecognition any gains or losses recognised in other comprehensive income are **not transferred** to **profit or loss**, although the cumulative gain or loss may be transferred within equity.

4.10.3 Example of IFRS 9 presentation

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)
PROFIT OR LOSS FOR THE YEAR

Liabilities at fair value (except derivatives and liabilities held for trading)	$'000
Change in fair value from own credit	90
Profit (loss) for the year	90

OTHER COMPREHENSIVE INCOME (NOT RECLASSIFIED TO PROFIT OR LOSS)

Fair value loss on financial liability attributable to change in credit risk	10
Total comprehensive income	100

4.10.4 Accounting mismatch

The new guidance allows the recognition of the full amount of change in the fair value in the profit or loss only if the recognition of changes in the liability's **credit risk** in other comprehensive income would **create** or **enlarge** an **accounting mismatch** in profit or loss. That determination is made at initial recognition and is not reassessed.

Other than the requirements regarding components of changes in the fair value of a liability relating to own credit, and the treatment of derivatives (not within this syllabus), the accounting requirements for liabilities are unchanged from IAS 39.

4.11 Impairment of financial assets

Note. Impairment is still governed by IAS 39.

At each year end, an entity should assess whether there is any objective evidence that a financial asset or group of assets is impaired.

Question

Give examples of indications that a financial asset or group of assets may be impaired.

Answer

IAS 39 lists the following:

(a) Significant financial difficulty of the issuer
(b) A breach of contract, such as a default in interest or principal payments
(c) The lender granting a concession to the borrower that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty
(d) It becomes probable that the borrower will enter bankruptcy
(e) The disappearance of an active market for that financial asset because of financial difficulties

Where there is objective evidence of impairment, the entity should **measure the amount** of any impairment loss.

The impairment loss is the **difference** between the asset's **carrying amount** and its **recoverable amount**. The asset's recoverable amount is the present value of estimated future cash flows, discounted at the financial instrument's **original** effective interest rate.

The amount of the loss should be **recognised in profit or loss**.

If the impairment loss decreases at a later date (and the decrease relates to an event occurring **after** the impairment was recognised) the reversal is recognised in profit or loss. The carrying amount of the asset must not exceed the original amortised cost.

4.12 Example: Impairment

Broadfield Co purchased 5% debentures in X Co on 1 January 20X3 (their issue date) for $100,000. The term of the debentures was five years and the maturity value is $130,525. The effective rate of interest on the debentures is 10% and the IFRS 9 conditions are satisfied for the investment to be held at amortised cost.

At the end of 20X4 X Co went into liquidation. All interest had been paid until that date. On 31 December 20X4 the liquidator of X Co announced that no further interest would be paid and only 80% of the maturity value would be repaid, on the original repayment date.

The market interest rate on similar bonds is 8% on that date.

Required

(a) What value should the debentures have been stated at just before the impairment became apparent?
(b) At what value should the debentures be stated at 31 December 20X4, after the impairment?
(c) How will the impairment be reported in the financial statements for the year ended 31 December 20X4?

Solution

(a) The debentures are classified as held at amortised cost:

	$
Initial cost	100,000
Interest at 10%	10,000
Cash at 5%	(5,000)
At 31 December 20X3	105,000
Interest at 10%	10,500
Cash at 5%	(5,000)
At 31 December 20X4	110,500

BPP LEARNING MEDIA

(b) After the impairment, the debentures are stated at their recoverable amount (using the **original** effective interest rate of 10%):

80% × $130,525 × 0.826 = $86,251

(c) The impairment of $24,249 ($110,500 – $86,251) should be recorded:

DEBIT Profit or loss	$24,249	
CREDIT Financial asset		$24,249

4.13 Section summary

- On initial recognition, **financial assets** are measured at **the fair value of the consideration given**. **Financial liabilities** are measured at the **fair value of the consideration received** *(IFRS 9)*
- Subsequent measurement depends on how a financial asset is **classified**. **Financial assets and financial liabilities** are classified at **amortised cost** or at **fair value**.
- Financial instruments at **fair value through profit or loss** are measured at **fair value**; gains and losses are recognised in **profit or loss**.
- Financial instruments at **amortised cost** are measured using the **effective interest method**.
- **Impairment of financial assets** is still governed by IAS 39.

FAST FORWARD

5 Embedded derivatives

An **embedded derivative** is a derivative instrument that is combined with a non-derivate **host contract** to form a single hybrid instrument

Certain contracts that are not themselves derivatives (and may not be financial instruments) include derivative contracts that are 'embedded' within them. These non-derivatives are called **host contracts**.

Key term

An **embedded derivative** is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument.

5.1 Examples of host contracts

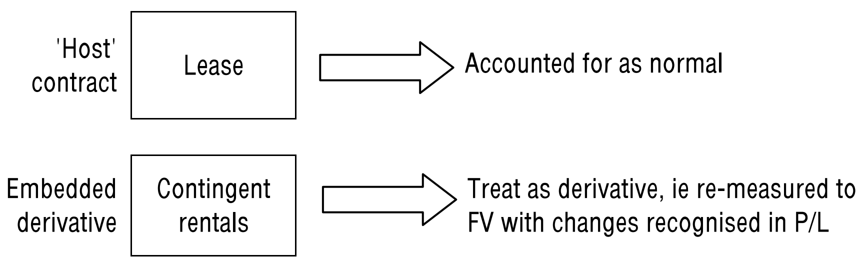
Possible examples include:

(a) A lease
(b) A debt or equity instrument
(c) An insurance contract
(d) A sale or purchase contract
(e) A construction contract

5.2 Examples of embedded derivatives

Possible examples include:

(a) A term in a lease of retail premises that provides for contingent rentals based on sales:



(b) A bond which is redeemable in five years' time with part of the redemption price being based on the increase in the FTSE 100 Index.

(c) Construction contract priced in a foreign currency. The construction contract is a non-derivative contract, but the changes in foreign exchange rate is the embedded derivative.

5.3 Accounting treatment of embedded derivatives

5.3.1 Financial asset host contract

Where the host contract is a financial asset within the scope of the standard, the classification and **measurement rules of the standard are applied to the entire hybrid contract**.

This is a simplification of the IAS 39 rules, which required that an embedded derivative be **separated from its host contract** and accounted for as a derivative under certain conditions. These rules applied to financial assets as well as other host contracts.

5.3.2 Other host contracts

Where the host contract is not a financial asset within the scope of IFRS 9, the standard requires that an embedded derivative be **separated from its host contract** and accounted for as a derivative when the following conditions are met.

(a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.

(b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

(c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the profit or loss (a derivative embedded in a financial liability need not be separated out if the entity holds the combined instrument at fair value through profit or loss).

5.4 Section summary

- Where the host contract is **an asset within the scope of IFRS 9** the hybrid contract is accounted for as **one instrument**.
- **Otherwise**, IFRS 9 requires that the embedded derivative is **separated from the host contract** where certain conditions are met and accounted for separately.

6 Hedge Accounting

FAST FORWARD

Hedge accounting is allowed in certain strictly defined circumstances.

6.1 Introduction

IAS 39 **requires hedge accounting** where there is a **designated hedging relationship** between a hedging instrument and a hedged item. It is **prohibited otherwise**.

Key terms

Hedging, for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

A **hedged item** is an asset, liability, firm commitment, or forecasted future transaction that:

(a) exposes the entity to risk of changes in fair value or changes in future cash flows, and that
(b) is designated as being hedged.

Key terms (cont'd)

A **hedging instrument** is a designated derivative or (in limited circumstances) another financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. (A non-derivative financial asset or liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.)

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. *(IAS 39)*

In simple terms, entities hedge to reduce their exposure to risk and uncertainty, such as changes in prices, interest rates or foreign exchange rates. Hedge accounting recognises hedging relationships by allowing (for example) losses on a hedged item to be offset against gains on a hedging instrument.

Generally only assets, liabilities etc that involve external parties can be designated as hedged items. The foreign currency risk of an intragroup monetary item (eg payable/receivable between two subsidiaries) may qualify as a hedged item in the group financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. This can happen (per IAS 21) when the transaction is between entities with different functional currencies.

In addition, the foreign currency risk of a highly probable group transaction may qualify as a hedged item if it is in a currency other than the functional currency of the entity and the foreign currency risk will affect profit or loss.

6.2 Conditions for hedge accounting

Before a hedging relationship qualifies for hedge accounting, **all** of the following **conditions** must be met.

(a) The hedging relationship must be **designated at its inception as a hedge** based on the entity's risk management objective and strategy. There must be formal documentation (including identification of the hedged item, the hedging instrument, the nature of the risk that is to be hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk).

(b) The hedge is expected to be **highly effective** in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. This means that the ratio of the gain or loss on the hedging instrument compared to the loss or gain on item being hedged is within the ratio 80% to 125%. (*Note*: the hedge need not necessarily be *fully* effective.)

(c) For **cash flow hedges**, a **forecast transaction** that is the subject of the hedge must be **highly probable** and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

(d) The effectiveness of the hedge can be **measured reliably**.

(e) The hedge is **assessed** on an ongoing basis (annually) and has been **effective during the reporting period**.

Key terms

Fair value hedge: a hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and could affect profit or loss.

Cash flow hedge: a hedge of the exposure to variability in cash flows that

(a) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction (such as an anticipated purchase or sale), and that

(b) could affect profit or loss.

Hedge of a net investment in a foreign operation: IAS 21 defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation. *(IAS 39)*

6.3 Example: Hedging

A company owns inventories of 20,000 gallons of oil which cost $400,000 on 1 December 20X3.

In order to hedge the fluctuation in the market value of the oil the company signs a futures contract to deliver 20,000 gallons of oil on 31 March 20X4 at the futures price of $22 per gallon.

The market price of oil on 31 December 20X3 is $23 per gallon and the futures price for delivery on 31 March 20X4 is $24 per gallon.

Required

Explain the impact of the transactions on the financial statements of the company:

(a) Without hedge accounting
(b) With hedge accounting.

Solution

The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the contract.

Without hedge accounting:

The futures contract is a derivative and therefore must be remeasured to fair value under IAS 39. The loss on the futures contract is recognised in profit or loss:

DEBIT	Profit or loss (20,000 × 24 – 22)	$40,000	
CREDIT	Financial liability		$40,000

With hedge accounting:

The loss on the futures contract is recognised in the profit or loss as before.

The inventories are revalued to fair value:

	$
Fair value at 31 December 20X3 (20,000 × 23)	460,000
Cost	(400,000)
Gain	60,000

The gain is also recognised in profit or loss:

DEBIT	Inventory	$60,000	
CREDIT	Profit or loss		$60,000

The net effect on the profit or loss is a gain of $20,000 compared with a loss of $40,000 without hedging.

The **standard** identifies three types of **hedging relationship**.

The hedge in the example above is a **fair value hedge** (it hedges exposure to changes in the fair value of a recognised asset: the oil).

6.4 Accounting treatment

6.4.1 Fair value hedges

The **gain or loss** resulting from **re-measuring** the hedging instrument at fair value is **recognised in profit or loss**.

The gain or loss on the hedged item attributable to the **hedged risk** should **adjust the carrying amount** of the hedged item and be **recognised in profit or loss**.

6.4.2 Example: fair value hedge

On 1 July 20X6 Joules acquired 10,000 ounces of a material which it held in its inventory. This cost $200 per ounce, so a total of $2 million. Joules was concerned that the price of this inventory would fall, so on 1 July 20X6 he sold 10,000 ounces in the futures market for $210 per ounce for delivery on 30 June 20X7. On 1 July 20X6 the conditions for hedge accounting were all met.

At 31 December 20X6, the end of Joules' reporting period, the fair value of the inventory was $220 per ounce while the futures price for 30 June 20X7 delivery was $227 per ounce. On 30 June 20X7 the trader sold the inventory and closed out the futures position at the then spot price of $230 per ounce.

Required

Set out the accounting entries in respect of the above transactions.

Solution

At 31 December 20X6 the increase in the fair value of the inventory was $200,000 (10,000 × ($220 – $200)) and the increase in the forward contract liability was $170,000 (10,000 × ($227 – $210)). Hedge effectiveness was 85% (170,000 as a % of 200,000), so hedge accounting was still permitted.

	Debit	*Credit*
31 December 20X6	$	$
Profit or loss	170,000	
Financial liability		170,000
(To record the loss on the forward contract)		
Inventories	200,000	
Profit or loss		200,000
(To record the increase in the fair value of the inventories)		

At 30 June 20X7 the increase in the fair value of the inventory was another $100,000 (10,000 × ($230 – $220)) and the increase in the forward contract liability was another $30,000 (10,000 × ($230 - $227)).

	Debit	*Credit*
	$	$
30 June 20X7		
Profit or loss	30,000	
Financial liability		30,000
(To record the loss on the forward contract)		
Inventories	100,000	
Profit or loss		100,000
(To record the increase in the fair value of the inventories)		
Profit or loss	2,300,000	
Inventories		2,300,000
(To record the inventories now sold)		
Cash	2,300,000	
Profit or loss – revenue		2,300,000
(To record the revenue from the sale of inventories)		
Financial liability	200,000	
Cash		200,000
(To record the settlement of the net balance due on closing the financial liability)		

Note that because the fair value of the material rose, Joules made a profit of only £100,000 on the sale of inventories. Without the forward contract, the profit would have been £300,000 (2,300,000 – 2,000,000). In the light of the rising fair value the trader might in practice have closed out the futures position earlier, rather than waiting until the settlement date.

6.4.3 Cash flow hedges

The portion of the gain or loss on the hedging instrument that is determined to be an **effective** hedge shall be **recognised directly in equity** through the statement of changes in equity.

The **ineffective portion** of the gain or loss on the hedging instrument should be **recognised in profit or loss**.

When a hedging transaction results in the recognition of an asset or liability, changes in the value of the hedging instrument recognised in equity either:

(a) Are adjusted against the carrying value of the asset or liability, or

(b) Affect the profit or loss at the same time as the hedged item (for example, through depreciation or sale).

6.4.4 Example: Cash flow hedge

Bets Co signs a contract on 1 November 20X1 to purchase an asset on 1 November 20X2 for €60,000,000. Bets reports in US$ and hedges this transaction by entering into a forward contract to buy €60,000,000 on 1 November 20X2 at US$1: €1.5.

Spot and forward exchange rates at the following dates are:

	Spot	*Forward (for delivery on 1.11.X2)*
1.11.X1	US$1: €1.45	US$1: €1.5
31.12.X1	US$1: €1.20	US$1: €1.24
1.11.X2	US$1: €1.0	US$1: €1.0 (actual)

Required

Show the double entries relating to these transactions at 1 November 20X1, 31 December 20X1 and 1 November 20X2.

Solution

Entries at 1 November 20X1

The value of the forward contract at inception is zero so no entries recorded (other than any transaction costs), but risk disclosures will be made.

The contractual commitment to buy the asset would be disclosed if material (IAS 16).

Entries at 31 December 20X1

Gain on forward contract:

	$
Value of contract at 31.12.X1 (€60,000,000/1.24)	48,387,096
Value of contract at 1.11.X1 (€60,000,000/1.5)	40,000,000
Gain on contract	8,387,096

Compare to movement in value of asset (unrecognised):

Increase in $ cost of asset

(€60,000,000/1.20 – €60,000,000/1.45) $8,620,690

As this is higher, the hedge is deemed fully effective at this point:

DEBIT Financial asset (Forward a/c)	$8,387,096	
CREDIT Equity		$8,387,096

Entries at 1 November 20X2

Additional gain on forward contract

	$
Value of contract at 1.11.X2 (€60,000,000/1.0)	60,000,000
Value of contract at 31.12.X1 (€60,000,000/1.24)	48,387,096
Gain on contract	11,612,904

Compare to movement in value of asset (unrecognised):

Increase in $ cost of asset

(€60,000,000/1.0 – €60,000,000/1.2)	$10,000,000

Therefore, the hedge is not fully effective during this period, but is still highly effective (and hence hedge accounting can be used):

$10,000,000/ $11,612,904 = 86% which is within the 80% – 125% bandings.

DEBIT Financial asset (Forward a/c)	$11,612,904	
CREDIT Equity		$10,000,000
CREDIT Profit or loss		$1,612,904

Purchase of asset at market price

DEBIT Asset (€60,000,000/1.0)	$60,000,000	
CREDIT Cash		$60,000,000

Settlement of forward contract

DEBIT Cash	$20,000,000	
CREDIT Financial asset (Forward a/c)		$20,000,000

Realisation of gain on hedging instrument

The cumulative gain of $18,387,096 recognised in equity:

- Is transferred to profit or loss as the asset is used, ie over the asset's useful life; or
- Adjusts the initial cost of the asset (reducing future depreciation).

6.5 Section summary

- **Hedge accounting** means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.
- **Hedge accounting** is permitted in certain circumstances, provided the hedging relationship is **clearly defined**, **measurable** and actually **effective**.
- There are three types of hedge: **fair value** hedge; **cash flow** hedge; hedge of a **net investment in a foreign operation**.
- The accounting treatment of a hedge **depends on its type**.
- The current hedging rules have been found to be **confusing and unrealistic when it comes to reflecting and disclosing an entity's risk management activities**.

7 Disclosure of financial instruments

Exam focus point

Skim through for background only – disclosures will not be tested in detail.

FAST FORWARD

IFRS 7 specifies the **disclosures** required for financial instruments. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

The IASB maintains that users of financial instruments need information about an entity's exposures to risks and how those risks are managed, as this information can **influence a user's assessment of the financial position and financial performance of an entity** or of the amount, timing and uncertainty of its **future cash flows**.

There have been new techniques and approaches to measuring risk management, which highlighted the need for guidance.

Accordingly, IFRS 7 *Financial instruments: Disclosures* was issued in 2005. The standard revises, enhances and replaces the disclosures in IAS 30 and IAS 32. The presentation aspects of IAS 32 are retained, and IAS 32 has been renamed *Financial instruments: Presentation.*

7.1 General requirements

The extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk. It **adds to the requirements previously in IAS 32** by requiring:

- Enhanced statement of financial position and statement of profit or loss and other comprehensive income disclosures
- Disclosures about an allowance account when one is used to reduce the carrying amount of impaired financial instruments.

The standard requires **qualitative and quantitative disclosures about exposure to risks** arising from financial instruments, and specifies minimum disclosures about **credit risk**, **liquidity risk** and **market risk**.

7.2 Objective

The objective of the IFRS is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) The significance of financial instruments for the entity's financial position and performance

(b) The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The principles in IFRS 7 complement the principles for recognising, measuring and presenting financial assets and financial liabilities in IAS 32 *Financial instruments: Presentation* and IAS 39 *Financial instruments: Recognition and measurement*.

7.3 Classes of financial instruments and levels of disclosure

The entity must group financial instruments into classes **appropriate to the nature of the information disclosed**. An entity must decide in the light of its circumstances how much detail it provides. Sufficient information must be provided to permit reconciliation to the line items presented in the statement of financial position.

7.3.1 Statement of financial position

The following must be disclosed.

(a) **Carrying amount** of financial assets and liabilities by IAS 39 category.

(b) **Reason for any reclassification** between fair value and amortised cost (and *vice versa*).

(c) **Details** of the assets and exposure to risk where the entity has made a **transfer** such that part or all of the financial assets do not qualify for derecognition.

(d) The **carrying amount** of financial assets the entity has **pledged as collateral** for liabilities or contingent liabilities and the associated terms and conditions.

(e) When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an **allowance account** used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it must disclose a **reconciliation** of changes in that account during the period for each class of financial assets.

(f) The **existence of multiple embedded derivatives**, where compound instruments contain these.

(g) Defaults and breaches.

7.3.2 Statement of comprehensive income

The entity must disclose the following **items of income, expense, gains or losses**, either on the face of the financial statements or in the notes.

(a) Net gains/losses by IAS 39 category (broken down as appropriate: eg interest, fair value changes, dividend income)

(b) Interest income/expense

(c) Impairments losses by class of financial asset

7.3.3 Other disclosures

Entities must disclose in the summary of **significant accounting policies** the measurement basis used in preparing the financial statements and the other accounting policies that are relevant to an understanding of the financial statements.

Hedge accounting

Disclosures must be made relating to **hedge accounting**, as follows:

(a) Description of hedge

(b) Description of financial instruments designated as **hedging instruments** and their fair value at the reporting date

(c) The **nature of the risks** being hedged

(d) For **cash flow hedges**, periods **when the cash flows will occur** and when will affect profit or loss

(e) For fair value hedges, gains or losses on the hedging instrument and the hedged item

(f) The **ineffectiveness recognised in profit or loss** arising from cash flow hedges and net investments in foreign operations.

Fair value

IFRS 7 retains the following general requirements in relation to the disclosure of fair value for those financial instruments **measured at amortised cost**:

(a) For each class of financial assets and financial liabilities an entity should disclose the **fair value of that class of assets and liabilities** in a way that permits it to be compared with its carrying amount.

(b) In disclosing fair values, an entity should group financial assets and financial liabilities into classes, but should **offset them only to the extent that their carrying amounts are offset in the statement of financial position**.

It also states that **disclosure of fair value is not required** where:

- Carrying amount is a reasonable approximation of fair value
- For investments in equity instruments that do not have a quoted market price in an active market for an identical instrument, or derivatives linked to such equity instruments

IFRS 13 (see Section 8) provides disclosure requirements in respect of the fair value of financial instruments **measured at fair values**. It requires that information is disclosed to help users assess:

(a) For assets and liabilities measured at **fair value after initial recognition**, **the valuation techniques and inputs used to develop those measurements**.

(b) For **recurring fair value measurements** (ie those measured at each period end) using significant unobservable (Level 3) inputs, the **effect of the measurements on profit or loss** or other comprehensive income for the period.

In order to achieve this, the following should be disclosed **as a minimum** for each class of financial assets and liabilities measured at fair value (asterisked disclosures are also required for financial assets and liabilities measured at amortised cost but for which fair value is disclosed).

(c) The fair value measurement at the end of the period.

(d) The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety.

(e) For assets and liabilities measured at fair value at each reporting date (recurring fair value measurements), the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy and reasons for the transfers.

(f) For fair value measurements categorised within Levels 2 and 3 of the hierarchy, a description of the valuation techniques and inputs used in the fair value measurement, plus details of any changes in valuation techniques.

(g) For recurring fair value measurements categorised within Level 3 of the fair value hierarchy:

   (i) A reconciliation from the opening to closing balances.

   (ii) The amount of unrealised gains or losses recognised in profit or loss in the period and the line item in which they are recognised.

   (iii) A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs.

(h) For recurring and non-recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity.

An entity should also disclose its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred.

7.3.4 Example: Fair value disclosures

For assets and liabilities measured at fair value at the end of the reporting period, the IFRS requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. An entity might disclose the following for assets:

	$'000	*Fair value measurements at the end of the reporting period using*		
Description	*31.12.X9*	*Level 1 inputs*	*Level 2 inputs*	*Level 3 inputs*
Trading equity securities	45	45		
Non-trading equity securities	32			32
Corporate securities	90	9	81	
Derivatives – interest rate contracts	78		78	
Total recurring fair value measurements	245	54	159	32

7.4 Nature and extent of risks arising from financial instruments

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of **different types of financial risk** as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

Credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
Liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
Loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
Market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk**, **interest rate risk** and **other price risk**.
Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from **interest rate risk** or **currency risk**), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
Past due	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

7.4.1 Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose:

(a) The **exposures to risk** and how they arise

(b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk

(c) Any **changes** in (a) or (b) from the previous period.

7.4.2 Quantitative disclosures

For each financial instrument risk, **summary quantitative data** about risk exposure must be disclosed. This should be based on the information provided internally to key management personnel. More information should be provided if this is unrepresentative.

Information about **credit risk** must be disclosed by class of financial instrument:

(a) Maximum exposure at the year end

(b) Any collateral pledged as security

(c) In respect of the amount disclosed in (b), a description of collateral held as security and other credit enhancements

(d) Information about the credit quality of financial assets that are neither **past due** nor impaired

(e) Financial assets that are past due or impaired, giving an age analysis and a description of collateral held by the entity as security

(f) Collateral and other credit enhancements obtained, including the nature and carrying amount of the assets and policy for disposing of assets not readily convertible into cash.

For **liquidity risk** entities must disclose:

(a) A maturity analysis of financial liabilities

(b) A description of the way risk is managed

Disclosures required in connection with **market risk** are:

(a) Sensitivity analysis, showing the effects on profit or loss of changes in each market risk
(b) If the sensitivity analysis reflects interdependencies between risk variables, such as interest rates and exchange rates the method, **assumptions and limitations** must be disclosed.

7.5 Capital disclosures

Certain disclosures about **capital** are required. An entity's capital does not relate solely to financial instruments, but has more general relevance. Accordingly, those disclosures are included in IAS 1, rather than in IFRS 7.

8 Fair value measurement

FAST FORWARD

IFRS 13 *Fair value measurement* gives extensive guidance on how the fair value of assets and liabilities should be established.

In May 2011 the IASB published IFRS 13 *Fair value measurement.* The project arose as a result of the Memorandum of Understanding between the IASB and FASB (2006) reaffirming their commitment to the convergence of IFRSs and US GAAP. With the publication of IFRS 13, IFRS and US GAAP now have the same definition of fair value and the measurement and disclosure requirements are now aligned.

IFRS 13 applies to a wide variety of different types of asset and liabilities, and is especially relevant to accounting for financial instruments. That is not to say, however, that it is not relevant in other areas: fair value is such a fundamental part of IFRSs that a list of all the places where IFRS 13 would be very similar to the list of IFRSs. It is important in your exam, therefore, that you are alive to the possibility that IFRS 13 might apply in areas other than financial instruments.

8.1 Objective

IFRS 13 sets out to:

(a) Define fair value
(b) Set out in a single IFRS a framework for measuring fair value
(c) Require disclosure about fair value measurements

8.2 Definitions

IFRS 13 defines fair value as '**the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date**'.

The previous definition used in IFRS was 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

The price which would be received to sell the asset or paid to transfer (not settle) the liability is described as the 'exit price' and this is the definition used in US GAAP. Although the concept of the 'arm's length transaction' has now gone, the market-based current exit price retains the notion of an exchange between unrelated, knowledgeable and willing parties.

8.3 Scope

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures. The measurement and disclosure requirements do not apply in the case of:

(a) Share-based payment transactions within the scope of IFRS 2 *Share-based payment*
(b) Leasing transactions within the scope of IAS 17 *Leases*; and
(c) Net realisable value as in IAS 2 *Inventories* or value in use as in IAS 36 *Impairment of assets.*

Disclosures are not required for:

(a) Plan assets measured at fair value in accordance with IAS 19 *Employee benefits*

(b) Plan investments measured at fair value in accordance with IAS 26 *Accounting and reporting by retirement benefit plans*; and

(c) Assets for which the recoverable amount is fair value less disposal costs under IAS 36 *Impairment of assets*

8.4 Measurement

Fair value is a market-based measurement, not an entity-specific measurement. It focuses on assets and liabilities and on exit (selling) prices. It also takes into account market conditions at the measurement date. In other words, it looks at the amount for which the holder of an asset could sell it and the amount which the holder of a liability would have to pay to transfer it. It can also be used to value an entity's own equity instruments.

Because it is a market-based measurement, fair value is measured using the assumptions that market participants would use when pricing the asset, taking into account any relevant characteristics of the asset.

It is assumed that the transaction to sell the asset or transfer the liability takes place either:

(a) In the *principal market* for the asset or liability; or

(b) In the absence of a principle market, in the *most advantageous* market for the asset or liability.

The principal market is the market which is the most liquid (has the greatest volume and level of activity) for that asset or liability. In most cases the principal market and the most advantageous market will be the same.

IFRS 13 acknowledges that when market activity declines an entity must use a valuation technique to measure fair value. In this case the emphasis must be on whether a transaction price is based on an **orderly transaction**, rather than a forced sale.

Fair value is **not adjusted for transaction costs.** Under IFRS 13, these are **not a feature of the asset or liability,** but may be taken into account when **determining the most advantageous market.**

Fair value measurements are based on an asset or a liability's **unit of account**, which is specified by each IFRS where a fair value measurement is required. For most assets and liabilities, the unit of account is the individual asset or liability, but in some instances may be a group of assets or liabilities.

8.4.1 Example: unit of account

A premium or discount on a large holding of the same shares (because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) is not considered when measuring fair value: the quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.

8.4.2 Example: principal or most advantageous market

An asset is sold in two active markets, Market X and Market Y, at $58 and $57, respectively. Valor Co does business in both markets and can access the price in those markets for the asset at the measurement date as follows.

	Market X	*Market Y*
	$	$
Price	58	57
Transaction costs	(4)	(3)
Transport costs (to transport the asset to that market)	(4)	(2)
	50	52

Remember that fair value is not adjusted for transaction costs. Under IFRS 13, these are not a feature of the asset or liability, but may be taken into account when determining the most advantageous market.

If Market X is the principal market for the asset (ie the market with the greatest volume and level of activity for the asset), the fair value of the asset would be $54, measured as the price that would be received in that market ($58) less transport costs ($4) and ignoring transaction costs.

If neither Market X nor Market Y is the principal market for the asset, Valor must measure the fair value of the asset using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account both transaction costs and transport costs (ie the net amount that would be received in the respective markets).

The maximum net amount (after deducting both transaction and transport costs) is obtainable in Market Y ($52, as opposed to $50). But this is not the fair value of the asset. The fair value of the asset is obtained by deducting transport costs but not transaction costs from the price received for the asset in Market Y: $57 less $2 = $55.

8.4.1 Non-financial assets

For **non-financial assets** the fair value measurement looks at the use to which the asset can be put. It takes into account the ability of a market participant to generate economic benefits by using the asset in its **highest and best** use.

8.5 Valuation techniques

IFRS 13 states that valuation techniques must be those which are appropriate and for which sufficient data are available. Entities should maximise the use of relevant **observable inputs** and minimise the use of **unobservable inputs**.

The standard establishes a three-level hierarchy for the inputs that valuation techniques use to measure fair value:

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date

Level 2 Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly, eg quoted prices for similar assets in active markets or for identical or similar assets in non active markets or use of quoted interest rates for valuation purposes

Level 3 Unobservable inputs for the asset or liability, ie using the entity's own assumptions about market exit value.

8.5.3 Valuation approaches

The IFRS identifies **three valuation approaches.**

(a) **Income approach.** Valuation techniques that convert future amounts (eg cash flows or income and expenses) to a single current (ie discounted) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts.

(b) **Market approach.** A valuation technique that uses prices and other relevant information generated by market transactions involving identical or comparable (ie similar) assets, liabilities or a group of assets and liabilities, such as a business.

(c) **Cost approach.** A valuation technique that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

Entities may use more than one valuation technique to measure fair value in a given situation. A change of valuation technique is considered to be a change of accounting estimate in accordance with IAS 8, and must be disclosed in the financial statements.

8.5.2 Examples of inputs used to measure fair value

	Asset or liability	Input
Level 1	Equity shares in a listed company	Unadjusted quoted prices in an active market
Level 2	Licensing arrangement arising from a business combination	Royalty rate in the contract with the unrelated party at inception of the arrangement
	Cash generating unit	Valuation multiple (eg a multiple of earnings or revenue or a similar performance measure) derived from observable market data, eg from prices in observed transactions involving comparable businesses
	Finished goods inventory at a retail outlet	Price to customers adjusted for differences between the condition and location of the inventory item and the comparable (ie similar) inventory items
	Building held and used	Price per square metre for the derived from observable market data, eg prices in observed transactions involving comparable buildings in similar locations
Level 3	Cash generating unit	Financial forecast (eg of cash flows or profit or loss) developed using the entity's own data
	Three-year option on exchange-traded shares	Historical volatility, ie the volatility for the shares derived from the shares' historical prices
		Adjustment to a mid-market consensus (non-binding) price for the swap developed using data not directly observable or otherwise corroborated by observable market data

8.6 Measuring liabilities

Fair value measurement of a liability assumes that that liability is transferred at the measurement date to a market participant, who is then obliged to fulfill the obligation. The obligation is not settled or otherwise extinguished on the measurement date.

8.6.1 Entity's own credit risk

The fair value of a liability reflects the effect of **non-performance risk,** which includes but is not limited to **the entity's own credit risk.** This may be different for different types of liabilities.

8.6.2 Example: Entity's own credit risk

Black Co and Blue Co both enter into a legal obligation to pay $20,000 cash to Green Go in seven years.

Black Co has a top credit rating and can borrow at 4%. Blue Co's credit rating is lower and it can borrow at 8%.

Black Co will receive approximately $15,200 in exchange for its promise. This is the present value of $20,000 in seven years at 4%.

Blue Co will receive approximately $11,660in exchange for its promise. This is the present value of $20,000 in seven years at 8%.

8.7 IFRS 13 and business combinations

Fair value generally applies on a business combination. This topic is covered in Chapter 22, together with some further examples.

8.8 Disclosure

An entity must disclose information that helps users of its financial statements assess both of the following:

(a) For assets and liabilities that are measured at fair value on a recurring or non-recurring basis, the valuation techniques and inputs used to develop those measurements.

(b) For recurring fair value measurements using significant **unobservable inputs** (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period. Disclosure requirements will include:

(i) Reconciliation from opening to closing balances
(ii) Quantitative information regarding the inputs used
(iii) Valuation processes used by the entity
(iv) Sensitivity to changes in inputs

8.9 Was the project necessary?

The IASB is already considering the matter of the measurement basis for assets and liabilities in financial reporting as part of its *Conceptual Framework* project. It could therefore be argued that it was not necessary to have a separate project on fair value. The *Conceptual Framework* might have been the more appropriate forum for discussing **when** fair value should be used **as well as how to define and measure it.**

However, it has been argued that a concise definition and clear measurement framework is needed because there is so much inconsistency in this area, and this may form the basis for discussions in the *Conceptual Framework* project.

The IASB has also pointed out that the global financial crisis has highlighted the need for:

- Clarifying how to measure fair value when the market for an asset becomes less active; and
- Improving the transparency of fair value measurements through disclosures about measurement uncertainty.

8.9.1 Advantages and disadvantages of fair value (v historical cost)

Fair value

Advantages

- Relevant to users' decisions
- Consistency between companies
- Predicts future cash flows

Disadvantages

- Subjective (not reliable)
- Hard to calculate if no active market
- Time and cost
- Lack of practical experience/familiarity
- Less useful for ratio analysis (bias)
- Misleading in a volatile market

Historical cost

Advantages

- Reliable
- Less open to manipulation
- Quick and easy to ascertain
- Matching (cost and revenue)
- Practical experience & familiarity

Disadvantages

- Less relevant to users' decisions
- Need for additional measure of recoverable amounts (impairment test)
- Does not predict future cash flows

Chapter Roundup

- Financial instruments can be very complex, particularly **derivative instruments**, although **primary instruments** are more straightforward.
- The important definitions to learn are:
  - **Financial asset**
  - **Financial liability**
  - **Equity instrument**
- Financial instruments must be classified as **liabilities** or **equity** according to their **substance**.
- The critical feature of a financial liability is the **contractual obligation to deliver cash** or another financial asset.
- **Compound instruments** are split into **equity** and **liability** components and presented accordingly in the statement of financial position.
- **IFRS 9 *Financial instruments***, issued in November 2009 and updated in October 2010 **replaced parts of IAS 39, with respect to the recognition, derecognition, classification and measurement of financial assets and liabilities**. In general, the rules were simplified. This standard is a work in progress and will fully replace IAS 39.
- **Financial assets** should **initially be measured** at **cost = fair value.**
- **Transaction costs increase this amount for financial assets** classified as measured at amortised cost, or where an irrevocable election has been made to take all gains and losses through other comprehensive income and **decrease this amount for financial liabilities** classified as measured at amortised cost.
- **Subsequent measurement** of both financial assets and financial liabilities **depends on how the instrument is classified:** at amortised cost or fair value.
- An **embedded derivative** is a derivative instrument that is combined with a non-derivative **host contract** to form a single hybrid instrument.
- **Hedge accounting** is allowed in certain strictly defined circumstances.
- **IFRS 7** specifies the **disclosures** required for financial instruments. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.
- **IFRS 13** *Fair value measurement* gives extensive guidance on how the fair value of assets and liabilities should be established.

Quick Quiz

1 Which issues are dealt with by IAS 32?

2 What items are not financial instruments according to IAS 32?

3 What is the critical feature used to identify a financial liability?

4 How should compound instruments be presented in the statement of financial position?

5 When should a financial asset be de-recognised?

6 How are financial instruments initially measured?

7 How are financial assets measured under IFRS 9, subsequent to initial recognition?

8 What is hedging?

9 Name the three types of hedging relationship identified by IAS 39.

10 Fill in the blanks:

In applying IFRS 13 *Fair value measurement,* entities should maximise the use of _______________ and minimise the use of _______________.

Answers to Quick Quiz

1 Classification and disclosure

2 Physical assets; prepaid expenses; non-contractual assets or liabilities; contractual rights not involving transfer of assets

3 The contractual obligation to deliver cash or another financial asset to the holder

4 By calculating the present value of the liability component and then deducting this from the instrument as a whole to leave a residual value for the equity component

5 An entity should derecognise a financial asset when:

   (a) The contractual rights to the cash flows from the financial asset expire, or

   (b) The entity transfers substantially all the risks and rewards of ownership of the financial asset to another party.

6 At cost = fair value

7 At amortised cost or at fair value.

8 Hedging, for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

9 Fair value hedge; cash flow hedge; hedge of a net investment in a foreign operation

10 Entities should maximise the use of relevant *observable inputs* and minimise the use of *unobservable inputs.*

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q14	Examination	20	36 mins
Q15	Examination	20	36 mins

12

Accounting for taxation

Topic list	Syllabus reference
1 Current tax	B10
2 Deferred tax	B10
3 Taxable temporary differences	B10
4 Deductible temporary differences	B10
5 Measurement and recognition of deferred tax	B10
6 Taxation in company accounts	B10
7 Deferred taxation and business combinations	B10
8 Government sales tax	B10

Introduction

In almost all countries entities are taxed on the basis of their trading income. In some countries this may be called corporation or corporate tax, but we will follow the terminology of IAS 12 *Income taxes* and call it income tax.

There are two aspects of income tax which must be accounted for: **current tax** and **deferred tax**. These will be discussed in Sections 1 and 2 respectively.

Study guide

B10	**Taxation in financial statements**
(a)	Account for current tax liabilities and assets in accordance with international accounting standards
(b)	Describe the general principles of government sales taxes (eg VAT or GST)
(c)	Explain the effect of taxable temporary differences on accounting and taxable profits
(d)	Outline the principles of accounting for deferred tax
(e)	Identify and account for the IASB requirements relating to deferred tax assets and liabilities
(f)	Calculate and record deferred tax amounts in the financial statements

1 Current tax

FAST FORWARD

Current tax is the amount payable to the tax authorities in relation to the trading activities of the period. It is generally straightforward.

1.1 Introduction

You may have assumed until now that accounting for income tax was a very simple matter for companies. You would calculate the amount of tax due to be paid on the company's taxable profits and you would:

DEBIT Tax charge (statement of profit or loss)
CREDIT Tax liability (statement of financial position)

with this amount.

Indeed, this aspect of corporate taxation – **current tax** – *is* ordinarily straightforward. Complexities arise, however, when we consider the future tax consequences of what is going on in the accounts now. This is an aspect of tax called **deferred tax**, which we will look at in the next section.

1.2 IAS 12 Income taxes

IAS 12 covers both current and deferred tax. The parts relating to current tax are fairly brief, because this is the simple and uncontroversial area of tax.

1.3 Definitions

These are some of the definitions given in IAS 12. We will look at the rest later.

Key terms

- **Accounting profit**. Net profit or loss for a period before deducting tax expense.
- **Taxable profit (tax loss)**. The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).
- **Tax expense (tax income)**. The aggregate amount included in the determination of net profit or loss for the period in respect of current tax and deferred tax.
- **Current tax**. The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. *(IAS 12)*

Before we go any further, let us be clear about the difference between current and deferred tax.

(a) **Current tax** is the amount *actually payable* to the tax authorities in relation to the trading activities of the entity during the period.

(b) **Deferred tax** is an *accounting measure*, used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results.

You should understand this a little better after working through Section 2.

1.4 Recognition of current tax liabilities and assets

IAS 12 requires any **unpaid tax** in respect of the current or prior periods to be recognised as a **liability**.

Conversely, any **excess tax** paid in respect of current or prior periods over what is due should be recognised as an **asset**.

Question — Current tax

In 20X8 Darton Co had taxable profits of $120,000. In the previous year (20X7) income tax on 20X7 profits had been estimated as $30,000. The corporate income tax rate is 30%.

Required

Calculate tax payable and the charge for 20X8 if the tax due on 20X7 profits was subsequently agreed with the tax authorities as:

(a) $35,000; or
(b) $25,000.

Any under or over payments are not settled until the following year's tax payment is due.

Answer

(a)

	$
Tax due on 20X8 profits ($120,000 × 30%)	36,000
Underpayment for 20X7	5,000
Tax charge and liability	41,000

(b)

	$
Tax due on 20X8 profits (as above)	36,000
Overpayment for 20X7	(5,000)
Tax charge and liability	31,000

Alternatively, the rebate due could be shown separately as income in the statement of comprehensive income and as an asset in the statement of financial position. An offset approach like this is, however, most likely.

Taking this a stage further, IAS 12 also requires recognition as an asset of the benefit relating to any tax loss that can be **carried back** to recover current tax of a previous period. This is acceptable because it is probable that the benefit will flow to the entity *and* it can be reliably measured.

1.5 Example: tax losses carried back

In 20X7 Eramu Co paid $50,000 in tax on its profits. In 20X8 the company made tax losses of $24,000. The local tax authority rules allow losses to be carried back to offset against current tax of prior years. The tax rate is 30%.

Required

Show the tax charge and tax liability for 20X8.

Solution

Tax repayment due on tax losses = 30% × $24,000 = $7,200.

The double entry will be:

DEBIT	Tax receivable (statement of financial position)	$7,200	
CREDIT	Tax repayment (statement of profit or loss)		$7,200

The tax receivable will be shown as an asset until the repayment is received from the tax authorities.

1.6 Measurement

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. They are measured at the **amount expected to be paid to (recovered from) the tax authorities**.

1.7 Recognition of current tax

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period, except in two cases.

(a) Tax arising from a **business combination** is treated differently (tax assets or liabilities of the acquired subsidiary will form part of the goodwill calculation).

(b) Tax arising from a transaction or event which is recognised **directly in equity** (in the same or a different period).

The rule in (b) is logical. If a transaction or event is charged or credited directly to equity, rather than to profit or loss, then the related tax should be also. An example of such a situation is where, under IAS 8, an adjustment is made to the **opening balance of retained earnings** due to either a change in accounting policy that is applied retrospectively, or to the correction of a material prior period error (see Chapter 7).

1.8 Presentation

In the statement of financial position, **tax assets and liabilities** should be shown separately from other assets and liabilities.

Current tax assets and liabilities can be **offset**, but this should happen only when certain conditions apply.

(a) The entity has a **legally enforceable right** to set off the recognised amounts.

(b) The entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

The **tax expense (income)** related to the profit or loss from ordinary activities should be shown in the statement of profit or loss.

The **disclosure requirements** of IAS 12 are extensive and we will look at these later in the chapter.

2 Deferred tax

FAST FORWARD

Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact. It is quite complex.

Exam focus point

Students invariably find deferred tax very confusing but it is a topic that is likely to appear in the exam.

2.1 What is deferred tax?

When a company recognises an asset or liability, it expects to **recover or settle the carrying amount** of that asset or liability. In other words, it expects to sell or use up assets, and to pay off liabilities. What happens if that recovery or settlement is likely to make future tax payments larger (or smaller) than they would otherwise have been if the recovery or settlement had no tax consequences? In these circumstances, IAS 12 requires companies to recognise a **deferred tax liability** (or **deferred tax asset**).

2.2 Definitions

Don't worry too much if you don't understand the concept of deferred tax yet; things should become clearer as you work through this section. First of all, here are the definitions relating to deferred tax given in IAS 12.

Key terms

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

- Deductible temporary differences
- The carry forward of unused tax losses
- The carry forward of unused tax credits

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

- **Taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled
- **Deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

(IAS 12)

We need to look at some of these definitions in more detail.

2.3 Tax base

We can expand on the definition given above by stating that the **tax base of an asset** is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying value of the asset. Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount.

Question

Tax base (1)

State the tax base of each of the following assets.

(a) A machine cost $10,000. For tax purposes, depreciation of $3,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.

(b) Interest receivable has a carrying amount of $1,000. The related interest revenue will be taxed on a cash basis.

(c) Trade receivables have a carrying amount of $10,000. The related revenue has already been included in taxable profit (tax loss).

(d) A loan receivable has a carrying amount of $1m. The repayment of the loan will have no tax consequences.

Answer

(a) The tax base of the machine is $7,000.
(b) The tax base of the interest receivable is nil.
(c) The tax base of the trade receivables is $10,000.
(d) The tax base of the loan is $1m.

In the case of a **liability**, the tax base will be its carrying amount, less any amount that will be deducted for tax purposes in relation to the liability in future periods. For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will *not* be taxable in future periods.

Question

Tax base (2)

State the tax base of each of the following liabilities.

(a) Current liabilities include accrued expenses with a carrying amount of $1,000. The related expense will be deducted for tax purposes on a cash basis.

(b) Current liabilities include interest revenue received in advance, with a carrying amount of $10,000. The related interest revenue was taxed on a cash basis.

(c) Current liabilities include accrued expenses with a carrying amount of $2,000. The related expense has already been deducted for tax purposes.

(d) Current liabilities include accrued fines and penalties with a carrying amount of $100. Fines and penalties are not deductible for tax purposes.

(e) A loan payable has a carrying amount of $1m. The repayment of the loan will have no tax consequences.

Answer

(a) The tax base of the accrued expenses is nil.
(b) The tax base of the interest received in advance is nil.
(c) The tax base of the accrued expenses is $2,000.
(d) The tax base of the accrued fines and penalties is $100.
(e) The tax base of the loan is $1m.

IAS 12 gives the following examples of circumstances in which the carrying amount of an asset or liability will be **equal to its tax base**.

- **Accrued expenses** which have already been deducted in determining an enterprise's current tax liability for the current or earlier periods.
- A **loan payable** is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- **Accrued expenses** which will never be deductible for tax purposes.
- **Accrued income** will never be taxable.

Exam focus point

The December 2013 exam featured a whole question on deferred tax, which included five marks for explaining how the tax base of an asset or liability is computed, and then stating the general recognition requirements of IAS 12 in relation to deferred tax assets and liabilities.

2.4 Temporary differences

You may have found the definition of temporary differences somewhat confusing. Remember that accounting profits form the basis for computing **taxable profits**, on which the tax liability for the year is calculated; however, accounting profits and taxable profits are different. There are two reasons for the differences.

(a) **Permanent differences**. These occur when certain items of revenue or expense are excluded from the computation of taxable profits (for example, entertainment expenses may not be allowable for tax purposes).

(b) **Temporary differences**. These occur when items of revenue or expense are included in both accounting profits and taxable profits, but not for the same accounting period. For example, an

expense which is allowable as a deduction in arriving at taxable profits for 20X7 might not be included in the financial accounts until 20X8 or later. In the long run, the total taxable profits and total accounting profits will be the same (except for permanent differences) so that timing differences originate in one period and are capable of reversal in one or more subsequent periods. Deferred tax is the tax attributable to **temporary differences.**

The distinction made in the definition between **taxable temporary differences** and **deductible temporary differences** can be made clearer by looking at the explanations and examples given in the standard and its appendices.

2.5 Section summary

- Deferred tax is an **accounting device**. It does *not* represent tax payable to the tax authorities.
- The **tax base** of an asset or liability is the value of that asset or liability for tax purposes.
- You should understand the difference between **permanent and temporary differences**.
- Deferred tax is the tax attributable to **temporary differences**.

3 Taxable temporary differences

FAST FORWARD

Deferred tax assets and liabilities arise from taxable and deductible temporary differences.

Exam focus point

The rule to remember here is that:

'All taxable temporary differences give rise to a deferred tax liability.'

3.1 Examples

The following are examples of circumstances that give rise to taxable temporary differences.

3.1.1 Transactions that affect the statement of profit or loss

(a) **Interest revenue** received in arrears and included in accounting profit on the basis of time apportionment. It is included in taxable profit, however, on a cash basis.

(b) **Sale of goods revenue** is included in accounting profit when the goods are delivered, but only included in taxable profit when cash is received.

(c) **Depreciation** of an asset is accelerated for tax purposes. When new assets are purchased, allowances may be available against taxable profits which exceed the amount of depreciation chargeable on the assets in the financial accounts for the year of purchase.

(d) **Development costs** which have been capitalised will be amortised in the statement of profit or loss, but they were deducted in full from taxable profit in the period in which they were incurred.

(e) **Prepaid expenses** have already been deducted on a cash basis in determining the taxable profit of the current or previous periods.

3.1.2 Transactions that affect the statement of financial position

(a) **Accounting depreciation of an asset** is not deductible for tax purposes. Deduction for tax purposes will be allowed through tax depreciation.

(b) A borrower records a **loan** at proceeds received (amount due at maturity) less transaction costs. The carrying amount of the loan is subsequently increased by amortisation of the transaction costs against accounting profit. The transaction costs were, however, deducted for tax purposes in the period when the loan was first recognised.

3.1.3 Fair value adjustments and revaluations

(a) **Current investments** or financial instruments are carried at fair value. This exceeds cost, but no equivalent adjustment is made for tax purposes.

(b) Property, plant and equipment can be **revalued** by an entity (under IAS 16), but no equivalent adjustment is made for tax purposes. This also applies to long-term investments. As the tax base remains at the original value, there will be a difference between the carrying value and the tax base, leading to an increase in the deferred tax provision.

3.2 Taxable temporary differences

Try to **understand the reasoning** behind the recognition of deferred tax liabilities on taxable temporary differences.

(a) When an **asset is recognised**, it is expected that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods.

(b) If the carrying amount of the asset is **greater than** its tax base, then taxable economic benefits will also be greater than the amount that will be allowed as a deduction for tax purposes.

(c) The difference is therefore a **taxable temporary difference** and the obligation to pay the resulting income taxes in future periods is a **deferred tax liability**.

(d) As the entity recovers the carrying amount of the asset, the taxable temporary difference will **reverse** and the enterprise will have taxable profit.

(e) It is then probable that economic benefits will flow from the entity in the form of **tax payments**, and so the recognition of all deferred tax liabilities (except those excluded above) is required by IAS 12.

3.3 Example: taxable temporary differences

A company purchased an asset costing $1,500. At the end of 20X8 the carrying amount is $1,000. The cumulative depreciation for tax purposes is $900 and the current tax rate is 25%.

Required

Calculate the deferred tax liability for the asset.

Solution

Firstly, what is the tax base of the asset? It is $1,500 – $900 = $600.

In order to recover the carrying value of $1,000, the entity must earn taxable income of $1,000, but it will only be able to deduct $600 as a taxable expense. The entity must therefore pay income tax of $400 × 25% = $100 when the carrying value of the asset is recovered.

The entity must therefore recognise a deferred tax liability of $400 × 25% = $100, recognising the difference between the carrying amount of $1,000 and the tax base of $600 as a taxable temporary difference.

3.4 Timing differences

Some temporary differences are often called **timing differences**, when income or expense is included in accounting profit in one period, but is included in taxable profit in a different period. The main types of taxable temporary differences which are timing differences and which result in deferred tax liabilities are:

- **Interest received** which is accounted for on an accruals basis, but which for tax purposes is included on a cash basis.
- **Accelerated depreciation** for tax purposes.
- Capitalised and amortised **development costs**.

3.5 Revalued assets

Under IAS 16 assets may be revalued. This changes the carrying amount of the asset but the tax base of the asset is not adjusted. Consequently, the taxable flow of economic benefits to the entity as the carrying value of the asset is recovered will differ from the amount that will be deductible for tax purposes.

The difference between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a **deferred tax liability or asset**.

The following question on accelerated depreciation should clarify some of the issues and introduce you to the calculations which may be necessary in the exam.

Question

Current and deferred tax

Jonquil Co buys equipment for $50,000 and depreciates it on a straight line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% per annum on a straight line basis. Tax losses may be carried back against taxable profit of the previous five years. In year 20X0, the entity's taxable profit was $25,000. The tax rate is 40%.

Required

Assuming nil profits/losses after depreciation in years 20X1 to 20X5 show the current and deferred tax impact in years 20X1 to 20X5 of the acquisition of the equipment.

Answer

Jonquil Co will recover the carrying amount of the equipment by using it to manufacture goods for resale. Therefore, the entity's current tax computation is as follows.

			Year		
	20X1	*20X2*	*20X3*	*20X4*	*20X5*
	$	$	$	$	$
Taxable income*	10,000	10,000	10,000	10,000	10,000
Depreciation for tax purposes	12,500	12,500	12,500	12,500	0
Taxable profit (tax loss)	(2,500)	(2,500)	(2,500)	(2,500)	10,000
Current tax expense (income) at 40%	(1,000)	(1,000)	(1,000)	(1,000)	4,000

* ie nil profit plus $50,000 ÷ 5 depreciation add-back.

The entity recognises a current tax asset at the end of years 20X1 to 20X4 because it recovers the benefit of the tax loss against the taxable profit of year 20X0.

The temporary differences associated with the equipment and the resulting deferred tax asset and liability and deferred tax expense and income are as follows.

			Year		
	20X1	*20X2*	*20X3*	*20X4*	*20X5*
	$	$	$	$	$
Carrying amount	40,000	30,000	20,000	10,000	0
Tax base	37,500	25,000	12,500	0	0
Taxable temporary difference	2,500	5,000	7,500	10,000	0
Opening deferred tax liability	0	1,000	2,000	3,000	4,000
Deferred tax expense (income): bal fig	1,000	1,000	1,000	1,000	(4,000)
Closing deferred tax liability @ 40%	1,000	2,000	3,000	4,000	0

The entity recognises the deferred tax liability in years 20X1 to 20X4 because the reversal of the taxable temporary difference will create taxable income in subsequent years. The entity's statement of profit or loss is as follows.

	Year				
	20X1	20X2	20X3	20X4	20X5
	$	$	$	$	$
Income	10,000	10,000	10,000	10,000	10,000
Depreciation	10,000	10,000	10,000	10,000	10,000
Profit before tax	0	0	0	0	0
Current tax expense (income)	(1,000)	(1,000)	(1,000)	(1,000)	4,000
Deferred tax expense (income)	1,000	1,000	1,000	1,000	(4,000)
Total tax expense (income)	0	0	0	0	0
Net profit for the year	0	0	0	0	0

3.6 Section summary

- Taxable temporary differences give rise to a **deferred tax liability**.
- Many taxable temporary differences are **timing differences**.
- Timing differences arise when income or an expense is included in accounting profit in one period, but in taxable profit in a **different period**.

4 Deductible temporary differences

4.1 Definition

Refer again to the definition given in Section 2 above.

Exam focus point

> The rule to remember here is that:
>
> 'All deductible temporary differences give rise to a deferred tax asset.'

There is a proviso, however. The deferred tax asset must also satisfy the **recognition criteria** given in IAS 12. This is that a deferred tax asset should be recognised for all deductible temporary differences to the extent that it is **probable that taxable profit will be available** against which it can be utilised. This is an application of prudence. Before we look at this issue in more detail, let us consider the examples of deductible temporary differences given in the standard.

4.2 Transactions that affect the statement of profit or loss

(a) **Retirement benefit costs** (pension costs) are deducted from accounting profit as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)

(b) **Accumulated depreciation** of an asset in the financial statements is greater than the accumulated depreciation allowed for tax purposes up to the end of the reporting period.

(c) The **cost of inventories** sold before the end of the reporting period is deducted from accounting profit when goods/services are delivered, but is deducted from taxable profit when the cash is received. (*Note.* There is also a taxable temporary difference associated with the related trade receivable, as noted in Section 3 above.)

(d) The **NRV** of inventory, or the **recoverable amount** of an item of property, plant and equipment falls and the carrying value is therefore **reduced**, but that reduction is ignored for tax purposes until the asset is sold.

(e) **Research costs** (or organisation/other start-up costs) are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.

(f) Income is **deferred** in the statement of financial position, but has already been included in taxable profit in current/prior periods.

(g) A **government grant** is included in the statement of financial position as deferred income, but it will not be taxable in future periods. (*Note.* A deferred tax asset may *not* be recognised here according to the standard.)

4.3 Fair value adjustments and revaluations

Current investments or **financial instruments** may be carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

4.4 Recognition of deductible temporary differences

Let us lay out the reasoning behind the recognition of deferred tax assets arising from deductible temporary differences.

(a) When a **liability is recognised**, it is assumed that its carrying amount will be settled in the form of outflows of economic benefits from the entity in future periods.

(b) When these resources flow from the entity, part or all may be deductible in determining taxable profits of a **period later** than that in which the liability is recognised.

(c) A **temporary tax difference** then exists between the carrying amount of the liability and its tax base.

(d) A **deferred tax asset** therefore arises, representing the income taxes that will be recoverable in future periods when that part of the liability is allowed as a deduction from taxable profit.

(e) Similarly, when the carrying amount of an asset is **less than its tax base**, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

4.5 Example: deductible temporary differences

Pargatha Co recognises a liability of $10,000 for accrued product warranty costs on 31 December 20X7. These product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 25%.

Required

State the deferred tax implications of this situation.

Solution

What is the tax base of the liability? It is nil (carrying amount of $10,000 less the amount that will be deductible for tax purposes in respect of the liability in future periods).

When the liability is settled for its carrying amount, the entity's future taxable profit will be reduced by $10,000 and so its future tax payments by $10,000 × 25% = $2,500.

The difference of $10,000 between the carrying amount ($10,000) and the tax base (nil) is a deductible temporary difference. The entity should therefore recognise a deferred tax asset of $10,000 × 25% = $2,500 **provided that** it is probable that the entity will earn sufficient taxable profits in future periods to benefit from a reduction in tax payments.

4.6 Taxable profits in future periods

When can we be sure that sufficient taxable profit will be available against which a deductible temporary difference can be utilised? IAS 12 states that this will be assumed when sufficient **taxable temporary differences** exist which relate to the same taxation authority and the same taxable entity. These should be expected to reverse:

(a) In the same period as the expected reversal of the deductible temporary difference, *or*

(b) In periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

Only in these circumstances is the deferred tax asset **recognised**, in the period in which the deductible temporary differences arise.

4.7 Unused tax losses and unused tax credits

An entity may have unused tax losses or credits (ie which it can offset against taxable profits) at the end of a period. Should a deferred tax asset be recognised in relation to such amounts? IAS 12 states that a deferred tax asset may be recognised in such circumstances **to the extent that it is probable future taxable profit will be available against which the unused tax losses/credits can be utilised**.

4.8 Section summary

- Deductible temporary differences give rise to a **deferred tax asset**.
- **Prudence** dictates that deferred tax assets can only be recognised when **sufficient future taxable profits** exist against which they can be utilised.

Exam focus point

The December 2013 exam had a full question on deferred tax (referred to above), in which 15 marks were available in relation to the tax consequences of three specific transactions.

5 Measurement and recognition of deferred tax

5.1 Basis of provision of deferred tax

IAS 12 adopts the **full provision** method of accounting for deferred tax.

The **full provision method** has the **advantage** that it recognises that each timing difference at the end of the reporting period has an effect on future tax payments. If a company claims an accelerated tax allowance on an item of plant, future tax assessments will be bigger than they would have been otherwise. Future transactions may well affect those assessments still further, but that is not relevant in assessing the position at the end of the reporting period.

5.2 Example

Suppose that Girdo Co begins trading on 1 January 20X7. In its first year it makes profits of $5m, the depreciation charge is $1m and the tax allowances on those assets is $1.5m. The rate of income tax is 30%.

Solution

The tax liability is $1.35m (30% × $m(5.0 + 1.0 –1.5), but the debit to profit or loss is increased by the deferred tax liability of 30% × $0.5m = $150,000. The total charge to profit or loss is therefore $1.5m which is an effective tax rate of 30% on accounting profits (ie 30% × $5.0m).

5.3 Changes in tax rates

Where the corporate rate of income tax **fluctuates from one year to another**, a problem arises in respect of the amount of deferred tax to be credited (debited) to the statement of profit or loss in later years.

IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply in the period **when the asset is realised or liability settled**, based on tax rates and laws enacted (or substantively enacted) at the end of the reporting period. In other words, IAS 12 requires the **liability method** to be used.

5.4 Discounting

Discounting is used to allow for the effect of the time value of money.

IAS 12 states that deferred tax assets and liabilities **should not be discounted** because of the complexities and difficulties involved. Discounting is applied to other non-current liabilities such as provisions and deferred payments.

5.5 Carrying amount of deferred tax assets

The carrying amount of deferred tax assets should be **reviewed at the end of each reporting period** and reduced where appropriate (insufficient future taxable profits). Such a reduction may be reversed in future years.

5.6 Recognition

As with current tax, deferred tax should normally be recognised as income or an expense and included in the net profit or loss for the year in the **statement of profit or loss**. Current and deferred tax will together make up the tax charge. The exception is where the tax arises from a transaction or event which is recognised (in the same or a different period) **directly in equity**.

The figures shown for deferred tax in the statement of profit or loss will consist of **two components**.

(a) Deferred tax relating to **timing differences**.

(b) Adjustments relating to **changes in the carrying amount of deferred tax assets/liabilities** (where there is no change in timing differences), eg changes in tax rates/laws, reassessment of the recoverability of deferred tax assets, or a change in the expected recovery of an asset.

Items in (b) will be recognised in profit or loss, *unless* they relate to items previously charged/credited to equity.

Deferred tax (and current tax) should be **charged/credited directly to equity** if the tax relates to items also charged/credited directly to equity (in the same or a different period).

Examples of IASs which allow certain items to be credited/charged directly to equity include:

(a) **Revaluations** of property, plant and equipment (IAS 16), and

(b) The effect of a **change in accounting policy** (applied retrospectively) or correction of a **material error** (IAS 8)

Revaluations will appear under 'other comprehensive income' in the statement of profit or loss and other comprehensive income and the tax element will be shown separately as 'Income tax relating to components of other comprehensive income'.

5.6.1 Example

Z Co owns a property which has a carrying value at the beginning of 20X9 of $1,500,000. At the year end it has entered into a contract to sell the property for $1,800,000. The tax rate is 30%. How will this be shown in the financial statements?

Solution

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	$'000
Profit for the year	X
Other comprehensive income:	
Gains on property revaluation	300
Income tax relating to components of other comprehensive income (300 × 30%)	(90)
Other comprehensive income for the year net of tax	210

The amounts will be posted as follows:

	Dr $'000	*Cr* $'000
Property, plant and equipment	300	
Deferred tax		90
Revaluation surplus		210

5.7 Why do we recognise deferred tax?

(a) Adjustments for deferred tax are made in accordance with the **accruals concept** and in accordance with the definition of a **liability** in the Conceptual Framework, ie a past event has given rise to an obligation in the form of increased taxation which will be payable in the future. The amount can be reliably estimated. A deferred tax asset similarly meets the definition of an **asset**.

(b) If the future tax consequences of transactions are not recognised, profit can be overstated, leading to overpayment of dividends and distortion of share price and EPS.

6 Taxation in company accounts

FAST FORWARD

In the statement of financial position the liability for tax payable is the tax on the current year profits. In the statement of profit or loss the tax on the current year profits is adjusted for transfers to or from the deferred tax balance and for prior year under- or over-provisions.

We have now looked at the 'ingredients' of taxation in company accounts. There are two aspects to be learned:

(a) Taxation on profits in the statement of profit or loss.
(b) Taxation payments due, shown as a liability in the statement of financial position.

6.1 Taxation in the statement of profit or loss

The tax on profit on ordinary activities is calculated by **aggregating**:

(a) **Income tax** on taxable profits
(b) **Transfers to or from deferred taxation**
(c) Any **under provision or overprovision** of income tax on profits of previous years

When income tax on profits is calculated, **the calculation is only an estimate of what the company thinks its tax liability will be. In subsequent dealings with the tax authorities, a different income tax charge might eventually be agreed.**

The difference between the estimated tax on profits for one year and the actual tax charge finally agreed for the year is made as an adjustment to taxation on profits in the following year, **resulting in the disclosure of either an underprovision or an overprovision of tax.**

Question — Tax payable

In the accounting year to 31 December 20X3, Neil Down Co made an operating profit before taxation of $110,000.

Income tax on the operating profit has been estimated as $45,000. In the previous year (20X2) income tax on 20X2 profits had been estimated as $38,000 but it was subsequently agreed at $40,500.

A transfer to the credit of the deferred taxation account of $16,000 will be made in 20X3.

Required

(a) Calculate the tax on profits for 20X3 for disclosure in the accounts.
(b) Calculate the amount of tax payable.

Answer

(a)		$
	Income tax on profits (liability in the statement of FP)	45,000
	Deferred taxation	16,000
	Underprovision of tax in previous year $(40,500 – 38,000)	2,500
	Tax on profits for 20X3 (profit or loss charge)	63,500

(b)		$
	Tax payable on 20X3 profits (liability)	45,000

6.2 Taxation in the statement of financial position

It should already be apparent from the previous examples that the income tax charge in the statement of profit or loss will not be the same as income tax liabilities in the statement of financial position.

In the statement of financial position, there are several items which we might expect to find.

(a) **Income tax may be payable** in respect of (say) interest payments paid in the last accounting return period of the year, or accrued.

(b) If no tax is payable (or very little), then there might be an **income tax recoverable asset** disclosed in current assets (income tax is normally recovered by offset against the tax liability for the year).

(c) There will usually be a **liability for tax**, possibly including the amounts due in respect of previous years but not yet paid.

(d) We may also find a **liability on the deferred taxation account**. Deferred taxation is shown under 'non-current liabilities' in the statement of financial position.

Question

Tax charge

For the year ended 31 July 20X4 Norman Kronkest Co made taxable trading profits of $1,200,000 on which income tax is payable at 30%.

(a) A transfer of $20,000 will be made to the deferred taxation account. The balance on this account was $100,000 before making any adjustments for items listed in this paragraph.

(b) The estimated tax on profits for the year ended 31 July 20X3 was $80,000, but tax has now been agreed at $84,000 and fully paid.

(c) Tax on profits for the year to 31 July 20X4 is payable on 1 May 20X5.

(d) In the year to 31 July 20X4 the company made a capital gain of $60,000 on the sale of some property. This gain is taxable at a rate of 30%.

Required

(a) Calculate the tax charge for the year to 31 July 20X4.

(b) Calculate the tax liabilities in the statement of financial position of Norman Kronkest as at 31 July 20X4.

Answer

(a) *Tax charge for the year*

		$
(i)	Tax on trading profits (30% of 1,200,000)	360,000
	Tax on capital gain (30% of 60,000)	18,000
	Deferred taxation	20,000
		398,000
	Underprovision of taxation in previous years $(84,000 – 80,000)	4,000
	Tax charge on profit for the period	402,000

(ii) *Note.* The statement of profit or loss will show the following.

	$
Profit before tax (1,200,000 + 60,000)	1,260,000
Income tax expense	(402,000)
Profit for the year	858,000

(b)

	$
Deferred taxation	
Balance brought forward	100,000
Transferred from profit or loss	20,000
Deferred taxation in the statement of financial position	120,000

The tax liability is as follows.

	$
Payable on 1 May 20X5	
Tax on profits (30% of $1,200,000)	360,000
Tax on capital gain (30% of $60,000)	18,000
Due on 1 May 20X5	378,000

	$
Summary	
Current liabilities	
Tax, payable on 1 May 20X5	378,000
Non-current liabilities	
Deferred taxation	120,000

Note. It may be helpful to show the journal entries for these items.

		$	$
DEBIT	Tax charge (statement of profit or loss)	402,000	
CREDIT	Tax payable		*382,000
	Deferred tax		20,000

* This account will show a debit balance of $4,000 until the underprovision is recorded, since payment has already been made: (360,000 + 18,000 + 4,000). The closing balance will therefore be $378.000.

6.3 Presentation of tax assets and liabilities

These should be **presented separately** from other assets and liabilities in the statement of financial position. Deferred tax assets and liabilities should be distinguished from current tax assets and liabilities.

In addition, deferred tax assets/liabilities should *not* be classified as current assets/liabilities, where an entity makes such a distinction.

There are only limited circumstances where **current tax** assets and liabilities may be **offset**. This should only occur if two things apply

(a) The entity has a legally enforceable right to set off the recognised amounts.

(b) The entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

Similar criteria apply to the **offset of deferred tax assets and liabilities**.

6.4 Presentation of tax expense

The tax expense or income related to the profit or loss for the year should be presented in the statement of profit or loss.

7 Deferred taxation and business combinations

FAST FORWARD

You must appreciate the deferred tax aspects of **business combinations**.

7.1 Tax bases

Remember the definition of the tax base of an asset or liability given in Section 2 above? In relation to business combinations and consolidations, IAS 12 gives (in an appendix) examples of circumstances that give rise to taxable temporary differences and to deductible temporary differences.

7.1.1 Circumstances that give rise to taxable temporary differences

- The carrying amount of an asset is increased to **fair value** in a business combination that is an acquisition and no equivalent adjustment is made for tax purposes
- **Unrealised losses resulting from intragroup transactions** are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment
- **Retained earnings** of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent
- Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by **changes in foreign exchange rates**
- An entity accounts in its own currency for the cost of the non-monetary assets of a foreign operation that is **integral to the reporting entity's operations** but the taxable profit or tax loss of the foreign operation is determined in the foreign currency

Question **Deferred tax and business combinations 1**

What are the consequences of the above situations?

Note. You may want to read through to the end of this section before you attempt this question.

Answer

(a) *Fair value adjustment*
On initial recognition, the resulting deferred tax liability increases goodwill or decreases negative goodwill.

(b) *Unrealised losses*
The tax bases of the assets are unaltered.

(c) *Consolidated earnings*
IAS 12 does not allow recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

(d) *Changes in exchange rates: investments*
There may be either a taxable temporary difference or a deductible temporary difference in this situation. IAS 12 does not allow recognition of the resulting deferred tax liability if the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

(e) *Changes in exchange rates: use of own currency*
Again, there may be either a taxable temporary difference or a deductible temporary difference. Where there is a taxable temporary difference, the resulting deferred tax liability is recognised, because it relates to the foreign operation's own assets and liabilities, rather than to the reporting **entity**'s investment in that foreign operation. The deferred tax is charged to profit or loss.

7.1.2 Circumstances that give rise to deductible temporary differences

- A **liability is recognised at its fair value** in a business combination that is an acquisition, but none of the related expense is deducted in determining taxable profit until a later period
- **Unrealised profits resulting from intragroup transactions** are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes
- Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by **changes in foreign exchange rates**
- A foreign operation accounts for its non-monetary assets in its own (functional) currency. If its taxable profit or loss is determined in a different currency (under the presentation currency method) changes in the exchange rate result in temporary differences. The resulting deferred tax is charged or credited to profit or loss.

Question

Deferred tax and business combinations 2

What are the consequences of the above situations?

Note. Again, you should read to the end of this section before you answer this question.

Answer

(a) *Fair value of liabilities*
The resulting deferred tax asset decreases goodwill or increases negative goodwill.

(b) *Unrealised profits*
As in above.

(c) *Changes in exchange rates: investments*
As noted in the question before this, there may be a taxable temporary difference or a deductible temporary difference. IAS 12 requires recognition of the resulting deferred tax asset to the extent, and only to the extent, that it is probable that:
    (i) The temporary difference will reverse in the foreseeable future; and
    (ii) Taxable profit will be available against which the temporary difference can be utilised.

(d) *Changes in exchange rates: use of own currency*
As noted in the question before this, there may be either a taxable temporary difference or a deductible temporary difference. Where there is a deductible temporary difference, the resulting deferred tax asset is recognised to the extent that it is probable that sufficient taxable profit will be available, because the deferred tax asset relates to the foreign operation's own assets and liabilities, rather than to the reporting **entity**'s investment in that foreign operation. The deferred tax is charged to profit or loss.

7.2 Taxable temporary differences

In a business combination, the cost of the acquisition must be allocated to the fair values of the identifiable assets and liabilities acquired as at the date of the transaction. Temporary differences will arise when the tax bases of the identifiable assets and liabilities acquired are not affected by the business combination or are affected differently. For example, the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner; a taxable temporary difference arises which results in a deferred tax liability and this will also affect goodwill.

7.3 Deductible temporary differences

In a business combination that is an acquisition, when a **liability** is recognised on acquisition but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises resulting in a deferred tax asset. A deferred tax asset will also arise when the fair value of an identifiable asset acquired is less than its tax base. In both these cases goodwill is affected (see below).

7.4 Investments in subsidiaries, branches and associates and interests in joint ventures

When such investments are held, **temporary differences** arise because the carrying amount of the investment (ie the parent's share of the net assets including goodwill) becomes different from the tax base (often the cost) of the investment. Why do these differences arise? These are some examples.

- There are **undistributable profits** held by subsidiaries, branches, associates and joint ventures
- There are **changes in foreign exchange rates** when a parent and its subsidiary are based in different countries
- There is a **reduction in the carrying amount** of an investment in an associate to its recoverable amount

The **temporary difference in the consolidated financial statements** may be different from the temporary difference associated with that investment in the parent's separate financial statements when the parent carries the investment in its separate financial statements at cost or revalued amount.

IAS 12 requires entities to **recognise a deferred tax liability** for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, *except* to the extent that both of these conditions are satisfied:

(a) The parent/investor/venturer is able to **control the timing of the reversal** of the temporary difference

(b) It is probable that the temporary difference **will not reverse** in the foreseeable future.

As well as the fact of parent control over reversal of temporary differences, it would often be **impracticable** to determine the amount of income taxes payable when the temporary differences reverses. So when the parent has determined that those profits will not be distributed in the foreseeable future, the parent does not recognise a deferred tax liability. The same applies to investments in branches.

Where a foreign operation's taxable profit or tax loss (and therefore the tax base of its non-monetary assets and liabilities) is determined in a **foreign currency**, changes in the exchange rate give rise to temporary differences. These relate to the foreign entity's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation, and so the reporting entity should recognise the resulting deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss.

An investor in an **associate** does not control that entity and so cannot determine its dividend policy. Without an agreement requiring that the profits of the associate should not be distributed in the foreseeable future, therefore, an investor should recognise a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. Where an investor cannot determine the exact amount of tax, but only a minimum amount, then the deferred tax liability should be that amount.

In a **joint venture**, the agreement between the parties usually deals with profit sharing. When a venturer can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred liability is not recognised.

IAS 12 then states that a **deferred tax asset** should be recognised for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that (and *only* to the extent that) both these are probable:

(a) That the temporary difference will **reverse** in the foreseeable future, **and**
(b) That **taxable profit** will be available against which the temporary difference can be utilised.

The **prudence principle** discussed above for the recognition of deferred tax assets should be considered.

7.5 Deferred tax assets of an acquired subsidiary

Deferred tax assets of a subsidiary may not satisfy the criteria for recognition when a business combination is initially accounted for but may be realised subsequently.

These should be recognised as follows:

- If recognised within 12 months of the acquisition date and resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to goodwill. If the carrying amount of goodwill is reduced to zero, any further amounts should be recognised in profit or loss.
- If recognised outside the 12 months 'measurement period' or not resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to profit or loss.

Question — Recognition

In 20X2 Jacko Co acquired a subsidiary, Jilly Co, which had deductible temporary differences of $3m. The tax rate at the date of acquisition was 30%. The resulting deferred tax asset of $0.9m was not recognised as an identifiable asset in determining the goodwill of $5m resulting from the business combination. Two years after the acquisition, Jacko Co decided that future taxable profit would probably be sufficient for the entity to recover the benefit of all the deductible temporary differences.

Required

(a) Consider the accounting treatment of the subsequent recognition of the deferred tax asset in 20X4.
(b) What would happen if the tax rate had risen to 40% by 20X4 or decreased to 20%?

Answer

(a) The entity recognises a deferred tax asset of $0.9m ($3m × 30%) and, in profit or loss statement, deferred tax income of $0.9m. It also reduces the cost of the goodwill by $0.9m and recognises an expense of $0.9m in profit or loss. The cost of goodwill is reduced to $4.1m, ie the amount that would have been recorded if a deferred tax asset of $0.9m had been recognised as an identifiable asset at the date of the business combination.

(b) If the tax rate rises to 40%, the entity should recognise a deferred tax asset of $1.2m ($3m × 40%) and, in profit or loss, deferred tax income of $1.2m.

If the tax rate falls to 20%, the entity should recognise a deferred tax asset of $0.6m ($3m × 20%) and deferred tax income of $0.6m.

In both cases, the entity will also reduce the cost of goodwill by $0.9m and recognise an expense for that amount in profit or loss.

7.6 Example: Deferred tax adjustments (1)

Red is a private limited liability company and has two 100% owned subsidiaries, Blue and Green, both themselves private limited liability companies. Red acquired Green on 1 January 20X2 for $5 million when the fair value of the net assets was $4 million, and the tax base of the net assets was $3.5 million. The acquisition of Green and Blue was part of a business strategy whereby Red would build up the 'value' of the group over a three-year period and then list its existing share capital on the stock exchange.

(a) The following details relate to the acquisition of Green, which manufactures electronic goods.

  (i) Part of the purchase price has been allocated to intangible assets because it relates to the acquisition of a database of key customers from Green. The recognition and measurement criteria for an intangible asset under IFRS 3 *Business combinations*/IAS 38 *Intangible assets* do not appear to have been met but the directors feel that the intangible asset of $0.5 million will be allowed for tax purposes and have computed the tax provision accordingly. However, the tax authorities could possibly challenge this opinion.

  (ii) Green has sold goods worth $3 million to Red since acquisition and made a profit of $1 million on the transaction. The inventory of these goods recorded in Red's statement of financial position at the year end of 31 May 20X2 was $1.8 million.

  (iii) The balance on the retained earnings of Green at acquisition was $2 million. The directors of Red have decided that, during the three years to the date that they intend to list the shares of the company, they will realise earnings through future dividend payments from the subsidiary amounting to $500,000 per year. Tax is payable on any remittance or dividends and no dividends have been declared for the current year.

(b) Blue was acquired on 1 June 20X1 and is a company which undertakes various projects ranging from debt factoring to investing in property and commodities. The following details relate to Blue for the year ending 31 May 20X2.

  (i) Blue has a portfolio of readily marketable government securities which are held as current assets. These investments are stated at market value in the statement of financial position with any gain or loss taken to profit or loss for the year. These gains and losses are taxed when the investments are sold. Currently the accumulated unrealised gains are $4 million.

  (ii) Blue has calculated that it requires a specific allowance of $2 million against loans in its portfolio. Tax relief is available when the specific loan is written off.

  (iii) When Red acquired Blue it had unused tax losses brought forward. At 1 June 20X1, it appeared that Blue would have sufficient taxable profit to realise the deferred tax asset created by these losses but subsequent events have proven that the future taxable profit will not be sufficient to realise all of the unused tax loss.

  The current tax rate for Red is 30% and for public companies is 35%.

Required

Write a note suitable for presentation to the partner of an accounting firm setting out the deferred tax implications of the above information for the Red Group of companies.

Solution: Deferred tax adjustments (1)

Acquisition of the subsidiaries – general

Fair value adjustments have been made for consolidation purposes in both cases and these will **affect** the **deferred tax charge for the year**. This is because the deferred tax position is viewed **from the perspective of the group as a whole**. For example, it may be possible to recognise deferred tax assets which previously could not be recognised by individual companies, because there are now sufficient tax profits available within the group to utilise unused tax losses. Therefore a **provision** should be made for **temporary differences between fair values of the identifiable net assets acquired and their carrying values** ($4 million less $3.5 million in respect of Green). **No provision should be made for the temporary difference** of $1 million arising on goodwill recognised as a result of the combination with Green.

Future listing

Red plans to seek a listing in three years' time. Therefore it will become a **public company** and will be subject to a **higher rate of tax**. IAS 12 states that deferred tax should be measured at the **average tax rates expected to apply in the periods in which the timing differences are expected to reverse**, based on current enacted tax rates and laws. This means that Red may be paying tax at the higher rate when some of its timing differences reverse and this should be taken into account in the calculation.

Acquisition of Green

(a) The directors have calculated the tax provision on the assumption that the intangible asset of $0.5 million will be allowed for tax purposes. However, this is not certain and the directors **may eventually have to pay the additional tax**. If the directors cannot be persuaded to adjust their calculations a **liability for the additional tax should be recognised**.

(b) The intra-group transaction has resulted in an **unrealised profit** of $0.6 million in the group accounts and this will be **eliminated on consolidation**. The tax charge in the group statement of profit or loss and other comprehensive income includes the tax on this profit, for which **the group will not become liable to tax until the following period. From the perspective of the group, there is a temporary difference**. Because the temporary difference arises in the financial statements of Red, **deferred tax should be provided** on this difference (an asset) using the rate of tax payable by Red.

(c) **Deferred tax should be recognised on the unremitted earnings of subsidiaries** unless the parent is able to **control the timing of dividend payments** or it is **unlikely that dividends will be paid for the foreseeable future**. Red controls the dividend policy of Green and this means that there would normally be no need to make a provision in respect of unremitted profits. However, the profits of Green **will be distributed** to Red over the next few years and **tax will be payable** on the dividends received. Therefore a **deferred tax liability should be shown**.

Acquisition of Blue

(a) A **temporary difference arises** where non-monetary assets are **revalued upwards** and the **tax treatment of the surplus is different from the accounting treatment**. In this case, the revaluation surplus has been **recognised in profit or loss** for the current period, rather than in equity but no corresponding adjustment has been made to the tax base of the investments because the gains will be taxed in future periods. Therefore the company **should recognise a deferred tax liability on the temporary difference of $4 million**.

(b) A temporary difference arises when the provision for the loss on the loan portfolio is first recognised. The general allowance is expected to increase and therefore it is unlikely that the temporary difference will reverse in the near future. However, a **deferred tax liability should still be recognised**. The temporary difference gives rise to a **deferred tax asset**. IAS 12 states that **deferred tax assets should not be recognised unless it is probable that taxable profits will be available** against which the taxable profits can be utilised. **This is affected by the situation in point (c) below**.

(c) In theory, unused tax losses give rise to a deferred tax asset. However, IAS 12 states that **deferred tax assets should only be recognised to the extent that they are regarded as recoverable**. They should be regarded as recoverable to the extent that on the basis of all the evidence available it is **probable that there will be suitable taxable profits against which the losses can be recovered**. The future taxable profit of Blue **will not be sufficient to realise all the unused tax loss. Therefore the deferred tax asset is reduced to the amount that is expected to be recovered**.

This reduction in the deferred tax asset implies that it was **overstated at 1 June 20X1**, when it was acquired by the group. As these are the first post-acquisition financial statements, **goodwill should also be adjusted**.

7.7 Example: Deferred tax adjustments 2

You are the accountant of Payit. Your assistant is preparing the consolidated financial statements of the year ended 31 March 20X2. However, he is unsure how to account for the deferred tax effects of certain transactions as he has not studied IAS 12. These transactions are given below.

Transaction 1
During the year, Payit sold goods to a subsidiary for $10 million, making a profit of 20% on selling price. 25% of these goods were still in the inventories of the subsidiary at 31 March 20X2. The subsidiary and Pay it are in the same tax jurisdiction and pay tax on profits at 30%.

Transaction 2
An overseas subsidiary made a loss adjusted for tax purposes of $8 million ($ equivalent). The only relief available for this tax loss is to carry it forward for offset against future taxable profits of the overseas subsidiary. Taxable profits of the oversees subsidiary suffer tax at a rate of 25%.

Required

Compute the effect of both the above transactions on the deferred tax amounts in the consolidated statement of financial position of Payit at 31 March 20X2. You should provide a full explanation for your calculations and indicate any assumptions you make in formulating your answer.

Solution: Deferred tax adjustments 2

Transaction 1

This intra-group sale will give rise to a **provision for unrealised profit** on the unsold inventory of $10,000,000 × 20% × 25% = $500,000. This provision must be made in the consolidated accounts. However, this profit has already been taxed in the financial statements of Payit. In other words there is a **timing difference**. In the following year when the stock is sold outside the group, the provision will be released, but the profit will not be taxed. The timing difference therefore gives rise to a **deferred tax asset**. The asset is 30% × $500,000 = $150,000.

Deferred tax assets are recognised to the extent that they are **recoverable**. This will be the case if **it is more likely than not** that **suitable tax profits** will exist from which the reversal of the timing difference giving rise to the asset can be deducted. The asset is carried forward on this assumption.

Transaction 2

An unrelieved tax loss gives rise to a **timing difference** because the loss is recognised in the financial statements but not yet allowed for tax purposes. When the overseas subsidiary generates sufficient taxable profits, the loss will be offset against these in arriving at taxable profits.

The amount of the deferred tax asset to be carried forward is 25% × $8m = $2m.
As with Transaction 1, deferred tax assets are recognised to the extent that they are **recoverable**. This will be the case if **it is more likely than not** that **suitable tax profits** will exist from which the reversal of the timing difference giving rise to the asset can be deducted.

7.8 Section summary

In relation to deferred tax and business combinations you should be familiar with:

- Circumstances that give rise to **taxable temporary differences**
- Circumstances that give rise to **deductible temporary differences**
- Their **treatment** once an acquisition takes place
- Reasons **why deferred tax arises** when investments are held
- **Recognition** of deferred tax on business combinations

8 Government sales tax

Most countries have a sales tax – a tax on the sale of certain goods and services. It **is usually a tax on turnover, not on profits**. The basic principle is that the tax should be borne by the final consumer. Different countries have their own ways of applying the tax, so in order to explain and illustrate the principles, the UK system is explained.

In the UK, registered traders may deduct the tax which they suffer on supplies to them (input tax) from the tax which they charge to their customers (output tax) at the time this is paid to the government or taxing authority. Thus, at each stage of the manufacturing or service process, the net tax paid is on the value added at that stage.

8.1 Example: Value Added Tax (VAT)

A forester sells wood to a furniture maker for £100 plus VAT. The furniture maker uses this wood to make a table and sells the table to a shop for £150 plus VAT. The shop then sells the table to the final consumer for £300 plus VAT of 20%. VAT will be accounted for to the UK government as follows.

	Cost	*Input tax 20%*	*Net sale price*	*Output tax 20%*	*Payable to HMRC*
	£	£	£	£	£
Forester	0	0	100	20.00	20.00
Furniture maker	100	20.00	150	30.00	10.00
Shop	150	30.00	300	60.00	30.00
					60.00

Because the traders involved account to the UK government for VAT charged less VAT suffered, their profits for income tax or corporation tax purposes are based on sales and purchases net of VAT.

8.2 Taxable Supplies

VAT is chargeable on taxable supplies made by a taxable person in the course or furtherance of any business carried on by him. Supplies may be of goods or services.

Key term

A **taxable supply** is a supply of goods or services, other than an exempt supply.

A taxable supply is either standard-rated or zero-rated. The standard rate in the UK is 20%.

Certain supplies, which fall within the classification of standard rate supplies, are charged at a reduced rate of 5%. An example is the supply of domestic fuel.

Zero-rated supplies are taxable at 0%. A taxable supplier whose outputs are zero-rated but whose inputs are standard-rated will obtain repayments of the VAT paid on purchases.

An exempt supply is not chargeable to VAT. A person making exempt supplies is unable to recover VAT on inputs. The exempt supplier thus has to shoulder the burden of VAT. Of course, he may increase his prices to pass on the charge, but he cannot issue a VAT invoice which would enable a taxable customer to obtain a credit for VAT, since no VAT is chargeable on his supplies.

8.3 Supplies of goods

Goods are supplied if exclusive ownership of the goods passes to another person.

The following are treated as supplies of goods.

- The supply of any form of power, heat, refrigeration or ventilation, or of water
- The grant, assignment or surrender of a major interest (the freehold or a lease for over 21 years) in land

- Taking goods permanently out of the business for the non-business use of a taxable person or for other private purposes including the supply of goods by an employer to an employee for his private use
- Transfers under an agreement contemplating a transfer of ownership, such as a hire purchase agreement

8.4 Supplies of services

Apart from a few specific exceptions, **any supply which is not a supply of goods and which is done for a consideration is a supply of services**. A consideration is any form of payment in money or in kind, including anything which is itself a supply.

A supply of services also takes place if:

- Goods are lent to someone for use outside the business
- Goods are hired to someone
- Services bought for business purposes are used for private purposes

The European Court of Justice has ruled that restaurants supply services rather than goods.

8.5 Taxable persons

The term 'person' includes individuals, partnerships (which are treated as single entities, ignoring the individual partners) and **companies. If a person is in business making taxable supplies, then the value of these supplies is called the taxable turnover. If a person's taxable turnover exceeds certain limits then he is a taxable person and should be registered for VAT**.

Chapter Roundup

- Current tax is the amount payable to the tax authorities in relation to the trading activities during the period. It is generally straightforward.
- Deferred tax is an accounting measure used to match the tax effects of transactions with their accounting impact. It is quite complex.
- **Deferred tax assets and liabilities** arise from deductible and taxable temporary differences.
- In the statement of financial position the liability for tax payable is the tax on the current year profits. In the statement of profit or loss the tax on current year profits is adjusted for transfers to or from the deferred tax balance and for prior year under- and over-provisions.
- You must appreciate the deferred tax aspects of **business combinations**.

Quick Quiz

1 What is the difference between 'current tax' and 'deferred tax'?

2 How should current tax be measured?

A The total liability, including deferred tax
B The amount expected to be paid to (or recovered from) the tax authorities
C The amount calculated on profit at current tax rates
D The amount calculated on profit at future tax rates

3 A taxable temporary difference gives rise to a deferred tax liability. True/False?

4 What is the basis of provision for deferred tax required by IAS 12?

5 What two methods can be used for calculating deferred tax when the tax rate changes?

6 Current tax assets and liabilities cannot be offset. True/False?

7 How do temporary differences arise when investments are held in subsidiaries, associates and so on?

8 The tax expense related to the profit for the year should be shown in the statement of profit or loss. True/False?

9 Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of ………………

10 Give three examples of temporary differences.

11 An entity has a tax overprovision relating to the prior year of $3,000. Taxable temporary differences have increased by $6,000 and profit for the year is $150,000. Tax is at 30%.

What is the charge to profit or loss?

Answers to Quick Quiz

1 (a) Current tax is the amount actually payable to the tax authorities.
(b) Deferred tax is used to match the tax effects of transactions with their accounting impact.

2 B The amount expected to be paid to (or recovered from) the tax authorities.

3 True.

4 Full provision

5
- Deferral method
- Liability method

6 False. They can be offset only if the entity has a legally enforceable right to offset *and* it intends to actually carry out the offset.

7 When the carrying amounts of the investment become different to the tax base of the investment.

8 True

9 Taxable temporary differences

10 Any three of:

- Interest revenue received in arrears
- Depreciation accelerated for tax purposes
- Development costs capitalised in the statement of financial position
- Prepayments
- Sale of goods revenue recognised before the cash is received

11 $43,800

	$
Tax on profit (150,000 × 30%)	45,000
Overprovision	(3,000)
Deferred tax increase (6,000 × 30%)	1,800
	43,800

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q16	Introductory	20	36 mins

13 Foreign currency transactions

Topic list	Syllabus reference
1 Foreign currency translation	B11
2 IAS 21: Individual company stage	B11
3 Functional and reporting currency	B11

Introduction

In a global economy most companies trade overseas, buying and selling assets in foreign currencies. You need to be able to record transactions in foreign currency and translate monetary and non-monetary items at the reporting date.

Study guide

B11	**The effects of changes in foreign currency exchange rates**
(a)	Discuss the recording of transactions and translation of monetary/non-monetary items at the reporting date for individual entities
(b)	Distinguish between reporting and functional currencies
(c)	Determine an entity's functional currency

1 Foreign currency translation

FAST FORWARD

Questions on foreign currency translation have always been popular with examiners. In general, you are required to prepare **consolidated accounts** for a group which includes a foreign subsidiary.

If a company trades overseas, it will buy or sell assets in foreign currencies. For example, an Indian company might buy materials from Canada, and pay for them in US dollars, and then sell its finished goods in Germany, receiving payment in Euros, or perhaps in some other currency. If the company owes money in a foreign currency at the end of the accounting year, or holds assets which were bought in a foreign currency, those liabilities or assets must be translated into the local currency (in this Text $), in order to be shown in the books of account.

A company might have a subsidiary abroad (ie a foreign entity that it owns), and the subsidiary will trade in its own local currency. The subsidiary will keep books of account and prepare its annual accounts in its own currency. However, at the year end, the holding company must 'consolidate' the results of the overseas subsidiary into its group accounts, so that somehow, the assets and liabilities and the annual profits of the subsidiary must be translated from the foreign currency into $.

If foreign currency exchange rates remained constant, there would be no accounting problem. As you will be aware, however, foreign exchange rates are continually changing, and it is not inconceivable for example, that the rate of exchange between the Polish zlotych and sterling might be Z6.2 to £1 at the start of the accounting year, and Z5.6 to £1 at the end of the year (in this example, a 10% increase in the relative strength of the zlotych).

There are two distinct types of foreign currency transaction, conversion and translation.

1.1 Conversion gains and losses

Conversion is the process of exchanging amounts of one foreign currency for another. For example, suppose a local company buys a large consignment of goods from a supplier in Germany. The order is placed on 1 May and the agreed price is €124,250. At the time of delivery the rate of foreign exchange was €3.50 to $1. The local company would record the amount owed in its books as follows.

DEBIT	Inventory account (124,250 ÷ 3.5)	$35,500	
CREDIT	Payables account		$35,500

When the local company comes to pay the supplier, it needs to obtain some foreign currency. By this time, however, if the rate of exchange has altered to €3.55 to $1, the cost of raising €124,250 would be (÷ 3.55) $35,000. The company would need to spend only $35,000 to settle a debt for inventories 'costing' $35,500. Since it would be administratively difficult to alter the value of the inventories in the company's books of account, it is more appropriate to record a profit on conversion of $500.

DEBIT	Payables account	$35,500	
CREDIT	Cash		$35,000
CREDIT	Profit on conversion		$500

Profits (or losses) on conversion would be included in profit of loss for the year in which conversion (whether payment or receipt) takes place.

Suppose that another home company sells goods to a Chinese company, and it is agreed that payment should be made in Chinese Yuan at a price of Y116,000. We will further assume that the exchange rate at the time of sale is Y10.75 to $1, but when the debt is eventually paid, the rate has altered to Y10.8 to $1. The company would record the sale as follows.

DEBIT	Receivables account (116,000 ÷ 10.75)	$10,800	
CREDIT	Sales account		$10,800

When the Y116,000 are paid, the local company will convert them into $, to obtain (÷ 10.8) $10,750. In this example, there has been a loss on conversion of $50 which will be written off to profit of loss for the year:

DEBIT	Cash	$10,750	
DEBIT	Loss on conversion	$50	
CREDIT	Receivables account		$10,800

There are **no accounting difficulties** concerned with foreign currency conversion gains or losses, and the procedures described above are uncontroversial.

1.2 Translation

Foreign currency translation, as distinct from conversion, does not involve the act of exchanging one currency for another. **Translation is required at the end of an accounting period when a company still holds assets or liabilities in its statement of financial position which were obtained or incurred in a foreign currency.**

These assets or liabilities might consist of any of the following.

(a) An individual home company holding individual **assets** or **liabilities** originating in a foreign currency 'deal'.

(b) An individual home company with a separate **branch** of the business operating abroad which keeps its own books of account in the local currency.

(c) A home company which wishes to consolidate the **results of a foreign subsidiary**.

There has been great **uncertainty** about the method which should be used to translate the following.

- Value of assets and liabilities from a foreign currency into $ for the year end statement of financial position
- Profits of an independent foreign branch or subsidiary into $ for the annual statement of profit or loss and other comprehensive income

Suppose, for example, that a Belgian subsidiary purchases a piece of property for €2,100,000 on 31 December 20X7. The rate of exchange at this time was €70 to $1. During 20X8, the subsidiary charged depreciation on the building of €16,800, so that at 31 December 20X8, the subsidiary recorded the asset as follows.

	€
Property at cost	2,100,000
Less accumulated depreciation	16,800
Net book value	2,083,200

At this date, the rate of exchange has changed to €60 to $1.

The local holding company must translate the asset's value into $, but there is a **choice of exchange rates**.

(a) Should the rate of exchange for translation be the rate which existed at the date of purchase, which would give a net book value of 2,083,200 ÷ 70 = $29,760?

(b) Should the rate of exchange for translation be the rate existing at the end of 20X8 (the closing rate of €60 to $1)? This would give a net book value of $34,720.

Similarly, should depreciation be charged to group profit or loss at the rate of €70 to $1 (the historical rate), €60 to $1 (the closing rate), or at an average rate for the year (say, €64 to $1)?

1.3 Consolidated accounts

If a parent has a subsidiary whose accounts are presented in a foreign currency, those accounts must be translated into the local currency before they can be included in the consolidated financial statements.

- Should the subsidiary's accounts be translated as if the subsidiary is an extension of the parent?
- Or should they be translated as if the subsidiary is a separate business?

As we will see in more detail later in the chapter, the translation rules will depend on which currency has most impact on the subsidiary. If this is the same as the parent's currency, the rules will follow those used in the financial statements of a single company (covered in Section 2 below).

Where a foreign operation is mainly exposed to a different currency and is effectively a separate business, the **closing rate** is used for most items in the statement of financial position **Exchange differences** are recognised in **other comprehensive income**.

We will look at the consolidation of foreign subsidiaries in much more detail in Section 3 of this chapter.

2 IAS 21: Individual company stage

The questions discussed above are addressed by IAS 21 *The effects of changes in foreign exchange rates*. We will examine those matters which affect single company accounts here.

2.1 Definitions

These are some of the definitions given by IAS 21.

Key terms

Foreign currency. A currency other than the functional currency of the entity.

Functional currency. The currency of the primary economic environment in which the entity operates.

Presentation currency. The currency in which the financial statements are presented.

Exchange rate. The ratio of exchange for two currencies.

Exchange difference. The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Closing rate. The spot exchange rate at the year end date.

Spot exchange rate. The exchange rate for immediate delivery.

Monetary items. Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. *(IAS 21)*

Each entity – whether an individual company, a parent of a group, or an operation within a group (such as a subsidiary, associate or branch) – should determine its **functional currency** and **measure its results and financial position in that currency**.

For most individual companies the functional currency will be the currency of the country in which they are located and in which they carry out most of their transactions. Determining the functional currency is much more likely to be an issue where an entity operates as part of a group. IAS 21 contains detailed guidance on how to determine an entity's functional currency and we will look at this in more detail in Section 3.

An entity can present its financial statements in any currency (or currencies) it chooses. IAS 21 deals with the situation in which financial statements are presented in a currency other than the functional currency.

Again, this is unlikely to be an issue for most individual companies. Their presentation currency will normally be the same as their functional currency (the currency of the country in which they operate). A company's presentation currency may be different from its functional currency if it operates within a group and we will look at this in Section 3.

2.2 Foreign currency transactions: initial recognition

IAS 21 states that a foreign currency transaction should be recorded, on initial recognition in the functional currency, by applying the exchange rate between the reporting currency and the foreign currency **at the date of the transaction** to the foreign currency amount.

An **average rate** for a period may be used if exchange rates do not fluctuate significantly.

2.3 Reporting at subsequent year ends

The following rules apply at each subsequent year end.

(a) Report foreign currency **monetary items** using the **closing rate**

(b) Report **non-monetary items** (eg non-current assets, inventories) which are carried at **historical cost** in a foreign currency using the **exchange rate at the date of the transaction** (historical rate)

(c) Report **non-monetary items** which are carried at **fair value** in a foreign currency using the exchange rates that existed **when the values were measured**.

2.4 Recognition of exchange differences

Exchange differences occur when there is a **change in the exchange rate** between the transaction date and the date of settlement of monetary items arising from a foreign currency transaction.

Exchange differences arising on the settlement of monetary items (receivables, payables, loans, cash in a foreign currency) or on translating an entity's monetary items at rates different from those at which they were translated initially, or reported in previous financial statements, should be **recognised in profit or loss** in the period in which they arise.

There are two situations to consider.

(a) The transaction is **settled in the same period** as that in which it occurred: all the exchange difference is recognised in that period.

(b) The transaction is **settled in a subsequent accounting period**: the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

In other words, where a monetary item has not been settled at the end of a period, it should be **restated using the closing exchange rate** and any gain or loss taken to profit or loss.

Question — Entries

White Cliffs Co, whose year end is 31 December, buys some goods from Rinka SA of France on 30 September. The invoice value is €40,000 and is due for settlement in equal instalments on 30 November and 31 January. The exchange rate moved as follows.

	€= $1
30 September	1.60
30 November	1.80
31 December	1.90
31 January	1.85

Required

State the accounting entries in the books of White Cliffs Co.

Answer

The purchase will be recorded in the books of White Cliffs Co using the rate of exchange ruling on 30 September.

DEBIT	Purchases	$25,000	
CREDIT	Trade payables		$25,000

Being the $ cost of goods purchased for €40,000 (€40,000 ÷ €1.60/$1)

On 30 November, White Cliffs must pay €20,000. This will cost €20,000 ÷ €1.80/$1 = $11,111 and the company has therefore made an exchange gain of $12,500 – $11,111 = $1,389.

DEBIT	Trade payables	$12,500	
CREDIT	Exchange gains: (P/L)		$1,389
CREDIT	Cash		$11,111

On 31 December, the year end, the outstanding liability will be recalculated using the rate applicable to that date: €20,000 ÷ €1.90/$1 = $10,526. A further exchange gain of $1,974 has been made and will be recorded as follows.

DEBIT	Trade payables	$1,974	
CREDIT	Exchange gains: (P/L)		$1,974

The total exchange gain of $3,363 will be included in the operating profit for the year ending 31 December.

On 31 January, White Cliffs must pay the second instalment of €20,000. This will cost them $10,811 (€20,000 ÷ €1.85/$1).

DEBIT	Trade payables	$10,526	
	Exchange losses: (P/L)	$285	
CREDIT	Cash		$10,811

When a gain or loss on a non-monetary item is recognised **in other comprehensive income** (for example, where property is revalued), any **related exchange differences** should also be **recognised in other comprehensive income.**

Exam focus point

The June 2013 paper included seven marks (in question two) in relation to loan finance denominated in a foreign currency. The finance cost of the loan needed to be recorded at the average rate, since it accrued over a period of time; the loan balance was translated at the closing rate because it was a monetary item; and an exchange loss was recognised in profit or loss.

This should all be within your grasp once you have studied the material in this chapter and, crucially, practised questions in this area.

3 Functional and reporting currency

FAST FORWARD

The functional currency is the currency of the primary economic environment in which the entity operates.

3.1 Determining functional currency

A holding or parent company with foreign operations must **translate the financial statements** of those operations into its own reporting currency before they can be consolidated into the group accounts. There are two methods: **the method used depends** upon **whether** the foreign operation has the **same functional currency as the parent**.

IAS 21 states that an entity should consider the following factors in determining its functional currency:

(a) The currency that mainly **influences sales prices** for goods and services (often the currency in which prices are denominated and settled)

(b) The currency of the **country whose competitive forces and regulations** mainly determine the sales prices of its goods and services

(c) The currency that mainly **influences labour, material and other costs** of providing goods or services (often the currency in which prices are denominated and settled)

Sometimes the functional currency of an entity is not immediately obvious. Management must then exercise judgement and may also need to consider:

(a) The currency in which **funds from financing activities** (raising loans and issuing equity) are generated
(b) The currency in which **receipts from operating activities** are usually retained

Where a parent has a foreign operation a number of factors are considered:

(a) Whether the activities of the foreign operation are carried out as an **extension of the parent**, rather than being carried out with a **significant degree of autonomy**.
(b) Whether **transactions with the parent** are a high or a low proportion of the foreign operation's activities.
(c) Whether **cash flows** from the activities of the foreign operation **directly affect the cash flows of the parent** and are readily available for remittance to it.
(d) Whether the activities of the foreign operation are **financed from its own cash flows** or by **borrowing from the parent**.

The translation method used has to reflect the economic reality of the relationship between the reporting entity (the parent) and the foreign operation.

3.1.1 Same functional currency as the reporting entity

In this situation, the foreign operation normally carries on its business as though it were an **extension of the reporting entity's operations.** For example, it may only sell goods imported from, and remit the proceeds directly to, the reporting entity.

Any **movement in the exchange rate** between the reporting currency and the foreign operation's currency will have an **immediate impact** on the reporting entity's cash flows from the foreign operations. In other words, changes in the exchange rate affect the **individual monetary items** held by the foreign operation, *not* the reporting entity's net investment in that operation.

3.1.2 Different functional currency from the reporting entity

In this situation, although the reporting entity may be able to exercise control, the foreign operation normally operates in a **semi-autonomous** way. It accumulates cash and other monetary items, generates income and incurs expenses, and may also arrange borrowings, all **in its own local currency**.

A change in the exchange rate will produce **little or no direct effect on the present and future cash flows** from operations of either the foreign operation or the reporting entity. Rather, the change in exchange rate affects the reporting entity's **net investment** in the foreign operation, not the individual monetary and non-monetary items held by the foreign operation.

FAST FORWARD

Practising examination questions is the best way of learning this topic.

3.2 Change in functional currency

The functional currency of an entity can be changed only if there is a change to the underlying transactions, events and conditions that are relevant to the entity. For example, an entity's functional currency may change if there is a change in the currency that mainly influences the sales price of goods and services.

Where there is a change in an entity's functional currency, the entity translates all items into the new functional currency **prospectively** (ie, from the date of the change) using the exchange rate at the date of the change.

3.3 Section summary

- In order to determine the functional currency of a foreign operation it is necessary to consider the **relationship** between the foreign operation and its parent:
  - If the foreign operation carries out its business as though it were an **extension of the parent's operations**, it almost certainly has the **same functional currency** as the parent.
  - If the foreign operation is **semi-autonomous** it almost certainly has **a different functional currency** from the parent.

Chapter Roundup

- Questions on foreign currency translation have always been popular with examiners. In general, you are required to prepare **consolidated accounts** for a group which includes a foreign subsidiary.
- The functional currency is the currency of the primary economic environment in which the entity operates.
- **Practising** examination questions is the best way of learning this topic.

Quick Quiz

1 What is the difference between conversion and translation?

2 Define 'monetary' items according to IAS 21.

3 How should foreign currency transactions be recognised initially in an individual enterprise's accounts?

4 When can an entity's functional currency be changed?

Answers to Quick Quiz

1 (a) Conversion is the process of exchanging one currency for another.
  (b) Translation is the restatement of the value of one currency in another currency.

2 Money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.

3 Use the exchange rate at the date of the transaction. An average rate for a period can be used if the exchange rates did not fluctuate significantly.

4 Only if there is a change to the underlying transactions relevant to the entity.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q17	Practice	10	18 mins

14 Accounting for agriculture and mineral resources

Topic list	Syllabus reference
1 IAS 41 Agriculture	B12
2 IFRS 6 Exploration for and evaluation of mineral resources: main proposals	B14

Introduction

In this chapter we deal with agriculture and biological assets (IAS 41) and mineral resources (IFRS 6).

Study Guide

B12	**Agriculture**
(a)	Recognise the scope of international accounting standards for agriculture
(b)	Discuss the recognition and measurement criteria including treatment of gains and losses, and the inability to measure fair value reliably
(c)	Identify and explain the treatment of government grants, and the presentation and disclosure of information relating to agriculture
(d)	Report on the transformation of biological assets and agricultural produce at the point of harvest and account for agriculture related government grants
B14	**Exploration and evaluation expenditures**
(a)	Outline the need for an accounting standard in this area and clarify its scope
(b)	Give examples of elements of cost that might be included in the initial measurement of exploration and evaluation assets
(c)	Describe how exploration and evaluation assets should be classified and reclassified
(d)	Explain when and how the exploration and evaluation assets should be tested for impairment
B5	**Intangible assets and goodwill**
(a)	Describe the method of accounting specified by the IASB for the exploration for and evaluation of mineral resources

1 IAS 41 Agriculture

FAST FORWARD

IAS 41 applies the requirements of IFRS to the treatment of biological assets.

Exam focus point

The topic was examined in June and December 2008, in December 2004 and in a 25 mark question in the pilot paper. This is not a very frequently-examined area, but IAS 41 has recently become more topical which increases the possibility of it coming up. Please give it proper attention and bear in mind that it fits well with IAS 20.

The importance of the agricultural sector in a country's economy will vary. It is reasonable to assume, however, that although agriculture is important in first world countries, it is likely to be of greater significance to developing countries

IAS 41 *Agriculture* was issued in February 2001.

IAS 41 has contributed to the international harmonisation of accounting standards, because agriculture in particular was characterised by a **great diversity in accounting treatments**. Cows, for instance, were accounted for as 'inventories' in Ireland but as 'non-current assets' in the UK. IAS 41 has helped to foster increased comparability between accounts produced in these different regions.

Question — Agriculture

If you work in agriculture, or if agriculture is important in your country, you may like to investigate the accounting treatment of items such as forestry activity or livestock activity in your country. Are there differences within your own country? How do these practices compare with other countries?

It is quite difficult to apply **traditional accounting methods** to agricultural activities, which explains why agriculture is excluded from many IASs.

(a) When and how do you account for the **critical events** associated with biological transformation (growth, procreation, production and degeneration), which alter the substance of biological assets?

(b) **Statement of financial position classification** is made difficult by the variety and characteristics of the living assets of agriculture.

(c) The nature of the management of agricultural activities also causes problems, particularly determination of the **unit of measurement**, ie whether biological assets are a perpetual group of assets or a number of limited life assets.

IAS 41 seeks to improve and harmonise practice in accounting for agriculture, which demonstrates fundamental **differences in its nature and characteristics** to other business activities.

1.1 Definitions

The following definitions are used in IAS 41 (you should be familiar with the definitions of fair value and carrying amount by now).

Key terms

- **Agricultural activity** is the management by an enterprise of the biological transformation of biological assets for sale, into agricultural produce or into additional biological assets.
- **Agricultural produce** is the harvested product of an enterprise's biological assets.
- A **biological asset** is a living animal or plant.
- **Biological transformation** comprises the processes of growth, degeneration, production and procreation that cause qualitative and quantitative changes in a biological asset.
- A **group of biological assets** is an aggregation of similar living animals or plants.
- **Harvest** is the detachment of produce from a biological asset or the cessation of a biological asset's life processes
- **Fair value** is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13)
- **Carrying amount** is the amount at which an asset is recognised in the statement of financial position.

(IAS 41)

Note the key parts of the definition of **agriculture**.

(a) **Biological**: agriculture relates to 'life phenomena', living animals and plants with an innate capacity of biological transformation which are dependent upon a combination of natural resources (sunlight, water, etc).

(b) **Transformation**: agriculture involves physical transformation, whereby animals and plants undergo a change in biological quantity (fat cover, density, etc) and/or quantity (progeny, live weight etc) over time, which is measured and monitored (increasingly objectively) as part of management control.

(c) **Management**: biological transformation is managed.

  (i) Conditions are stabilised or enhanced

  (ii) The transparency of the relationship between inputs and outputs is determined by the degree of control (intensive versus extensive)

  (iii) It is different from exploitation through extraction, where no attempt is made to facilitate the transformation

  (iv) Biological assets are managed in groups of plant or animal classes, using individual assets to ensure the sustainability of the group

  (v) Sustainability of an agricultural activity is a function of quality and quantity

(d) **Produce**: agricultural produce is diverse and may require further processing before ultimate consumption.

Question

Before we look at the way the standard tackles accounting for agriculture, can you think of some of the main accounting issues, given some of the things we have looked at so far?

Answer

The standard lists the following.

(a) Biological assets meet the definition and recognition criteria of tangible assets (see IAS 16).

(b) Biological transformation is the source of sector uniqueness and significant events within agricultural activities.

(c) Biological transformations are critical events separable from the transactions entered into to facilitate them.

(d) In agricultural activities there is a general lack of clarity in the relationship between inputs and outputs which increases the complexity of the allocation process, ie between joint costs and joint products.

(e) A consistent basis of management must be applied to all outcomes to produce meaningful representations of current period performance, because of the range of outcomes and lack of traceability. This means that both biological assets and agricultural produce should be measured using the same basis.

(f) Active and efficient markets for both biological assets and agricultural produce increases the reliability of measures of net market value and existing use value respectively.

(g) Using the class or collective of biological assets as a unit of measurement has implications for: measurement (the class is more reliable than the individual, future benefits not confined to immediately available uses, values are normally expressed in the collective); for classification (a collective is a regenerative perpetual asset, even though individual members have a limited life); and for going concern (sustainability is an important indicator of going concern).

(h) Different agricultural activities have different risk and reward characteristics and will therefore be reported under different segments (see IFRS 8, Chapter 18).

1.2 Scope

FAST FORWARD

In relation to agriculture you should be able to discuss:

- Accounting for biological assets
- Transformation and changes in substance
- Unit of measurement and changes in the carrying amount

The standard applies to the three elements that form part of, or result from, agricultural activity.

- Biological assets
- Agricultural produce at the point of harvest
- Government grants

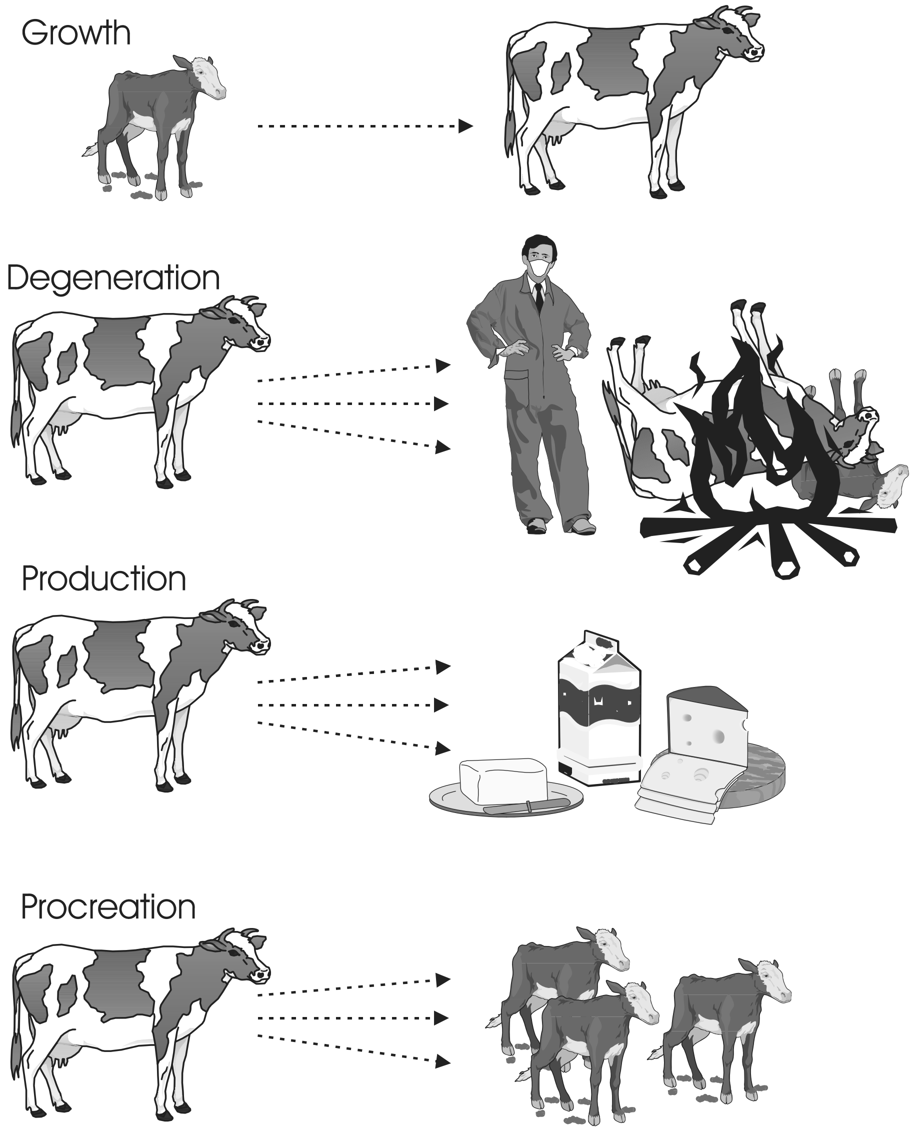
The standard does not apply to agricultural land (IASs 16 and 40) or intangible assets related to agricultural activity (IAS 38). After harvest, IAS 2 is applied.

1.3 Biological assets

We have seen the definition given above. Biological assets are the core income-producing assets of agricultural activities, held for their transformative capabilities. **Biological transformation** leads to various **different outcomes**.

- **Asset changes:**
  - Growth: increase in quantity and or quality
  - Degeneration: decrease in quantity and/or quality
- **Creation of new assets:**
  - Production: producing separable non-living products
  - Procreation: producing separable living animals

The above can be depicted as follows.



We can distinguish between the importance of these by saying that asset changes are **critical to the flow of future economic benefits** both in and beyond the current period, but the relative importance of new asset creation will depend on the purpose of the agricultural activity.

The IAS distinguishes therefore between two broad categories of agricultural production system.

(a) **Consumable**: animals/plants themselves are harvested
(b) **Bearer**: animals/plants bear produce for harvest

A few further points are made.

(a) Biological assets are usually managed in groups of animal or plant classes, with characteristics (eg male/female ratio) which allow **sustainability in perpetuity**.

(b) **Land often forms an integral part** of the activity itself in pastoral and other land-based agricultural activities.

The Standard then goes on to look at the principal issues in accounting for biological assets.

1.3.1 Recognition of biological assets

The recognition criteria are very **similar to those for other assets**, in that animals or plants should be recognised as assets in the following circumstances.

(a) The entity **controls** the asset as a result of past events
(b) It is probable that the **future economic benefits** associated with the asset will flow to the entity
(c) The fair value or cost of the asset to the entity can be **measured reliably**

The significant physical attributes of biological assets can be measured using various methods (which are used by markets to measure value) and generally indicate the source of future economic benefits. The **certainty** of the flow of rewards can be determined by formal ownership records, eg land title, branding. The availability of both cost and value for biological assets indicates the reliability aspect of the measurement criteria is fulfilled.

1.3.2 Measurement of biological assets

The IAS provides for a benchmark treatment and an allowed alternative treatment.

Benchmark treatment	Allowed alternative treatment
Fair value less costs to sell	Cost less accumulated depreciation and impairment losses

The IAS requires that at each year end **all biological assets should be measured at fair value** less estimated point-of-sale costs.

The IAS allows an alternative method of valuation, if a fair value cannot be determined because market-determined prices or values are not available. Then the biological asset can be measured at cost less accumulated depreciation and impairment losses.

This alternative basis is only allowed on **initial recognition.**

The **measurement basis** used to depict the fair value of a biological asset will differ depending on the existence of an active market, market efficiency and the use made of the asset. In summary, it is felt that **fair value**, when compared to historical cost, has greater relevance, reliability, comparability and understandability as a measure of future economic benefits.

1.3.3 Determining fair value

The standard states that the primary indicator of fair value should be **net market value**. This is reasonable as efficient markets exist for most biological assets in most locations and net market value is usually considered as providing the best evidence of fair value where an active market exists. Markets will generally differentiate between differing **qualities and quantities**. Market value is not generally predicated on management's intended use, however, but recognises alternative uses.

IFRS 13 requires the fair value of a biological asset to be determined by reference to the **principal market** for the asset. This may or may not be the most favourable market.

An active and efficient market may not be available for a class of biological assets in a specific location, or there may be imperfections in the market. The standard goes into some detail about **how fair value should be measured** in such circumstances, but in summary the valuation techniques should be consistent with

the objectives of measuring fair value and should attain an appropriate balance between relevance and reliability.

1.3.4 Recognition

This is an important principle, whereby the change in the carrying amount for a group of biological assets should be allocated between:

(a) The change attributable to **differences in fair value,** and

(b) The **physical change** in biological assets held.

The total change in carrying value between the beginning and end of the period thus consists of two components. Although the separation of these two components might appear impractical, the Standard states that separate disclosure of each is **fundamental to appraising current period performance and future prospects**. This is because they will not be reported in the same way in the financial statements.

(a) The change in carrying amount attributable to the **physical change in biological assets** must be recognised as income or expense and described as the change in biological assets. This allows management's performance to be evaluated in relation to the production from, and maintenance and renewal of, biological assets. This is the 'operating' part of the change in carrying amount.

(b) The change in carrying amount attributable to **differences in fair value** should be recognised in the statement of non-owner movements in equity and presented in equity under the heading of surplus/(deficit) on fair valuation of biological assets. This is the 'holding' part of the change in carrying amount.

In the **statement of financial position** the biological assets must be shown at fair value, incorporating the consequences of all biological transformations. These assets, with their differing risk and return characteristics, should be identified clearly.

The recommended **method of separating the above components** is to calculate the change attributable to the differences in fair value by restating biological assets on hand at the opening reporting date using end of period fair values and comparing this with the closing carrying amount. The biological assets on hand at the beginning and end of the period will then be expressed in a common measurement unit, ie period-end fair value. This allows the relative significance of sales, disposals, purchases, additions and biological transformations to be evaluated in relation to the overall change in substance of the biological assets held during the period.

There are **exceptions to this approach** in certain situations. For example, in some agricultural systems the predominant activity has a production cycle of less than a year (eg broiler chickens, mushroom growing, cereal crops). In such cases the total change in carrying amount is reported in the statement of profit or loss as a single item of income or expense.

On other occasions, the consequences of an **extraordinary item** may form part of the total change in biological assets. This should be disclosed separately as required by IAS 8 on the face of the statement of profit or loss after the profit or loss on ordinary activities, rather than being included in the change in biological assets recognised as income or expense. It should also appear as a separate item in the reconciliation to determine the change attributable to biological transformation.

Any other events giving rise to a change in biological assets of such a **size, nature or incidence** that their disclosure is relevant to explain the entity's performance (as defined in IAS 8) should be included in the change in biological assets recognised as income or expense. They should, however, be shown as a separate item in the reconciliation required to determine the change attributable to biological transformation.

1.3.5 Presentation and disclosure

In the **statement of financial position** biological assets should be classified as a separate class of assets falling under neither current nor non-current classifications. This reflects the view of such assets as having an unlimited life on a collective basis; it is the total exposure of the entity to this type of asset that is important.

Biological assets should also be **sub-classified** (either on the face of the statement of financial position or as a note to the accounts).

(a) Class of animal or plant
(b) Nature of activities (consumable or bearer)
(c) Maturity or immaturity for intended purpose

Where activities are **consumable**, the maturity criterion will be attainment of harvestable specifications, whereas in **bearer** activities, it will be attainment of sufficient maturity to sustain economic harvests.

1.4 Agricultural produce

This was defined in the key terms above. It is **recognised at the point of harvest** (eg detachment from the biological asset). Agricultural produce is either incapable of biological process or such processes remain dormant (eg stored grain). **Recognition ends** once the produce enters trading activities or production processes within integrated agribusinesses, although processing activities that are incidental to agricultural activities and that do not materially alter the form of the produce (eg drying or cleaning) are not counted as processing. Following harvest, the provisions of IAS 2 apply.

1.4.1 Measurement and presentation

Following the treatment of biological assets above, the IAS states that agricultural produce should be **measured at each reporting date at fair value** less estimated point-of-sale costs, to the extent that it is sourced from an enterprise's biological assets, which are also valued at fair value. This is logical when you consider that, until harvest, the agricultural produce was valued at fair value anyway as part of the biological asset.

The **change in the carrying amount** of the agricultural produce held at two reporting dates should be recognised as **income or expense** in the statement of profit or loss. This will be rare as such produce is usually sold or processed within a short time, so that produce held over two reporting dates is being held for a specific management purpose and the consequences of that should be reflected in the current period.

Agricultural produce that is harvested for **trading or processing activities** within integrated agricultural/ agribusiness operations should be measured at **fair value** at the date of harvest and this amount is deemed cost for application of IAS 2 to consequential inventories.

1.4.2 Presentation in the statement of financial position

Agricultural produce should be classified as inventory in the statement of financial position and disclosed separately either in the statement of financial position or in the notes.

1.5 Government grants related to agriculture

FAST FORWARD

In relation to government grants you should be able to explain treatment, presentation and disclosure.

An unconditional government grant related to a biological asset measured at its fair value less estimated point-of-sale costs should be recognised as income when, and only when, the grant becomes receivable.

If a government grant requires an entity not to engage in specified agricultural activity (eg the EU's set aside grant), an entity should only recognise the grant as income when, and only when, the conditions are met.

IAS 20 does not apply to a government grant on biological assets measured at fair value less estimated point-of-sale costs. However if a biological asset is measured at cost less accumulated depreciation and accumulated impairment loses then IAS 20 does apply.

1.6 Section summary

In relation to agriculture you should be able to discuss:

- Accounting for **biological assets**
- **Transformation** and changes in substance
- **Unit of measurement** and changes in the carrying amount

2 IFRS 6 Exploration for and evaluation of mineral resources: main proposals

FAST FORWARD

IFRS 6 requires that mineral resources on initial recognition are measured at cost.

– Subsequent measurement may be based on either the **cost model** or the **revaluation model**.
– Assets must be assessed for impairment in accordance with IAS 36.

2.1 Reasons for issuing IFRS 6

IFRS 6 is an interim standard. It is only a short-term solution to the problems of accounting in this area, and was issued so that entities had at least *some* guidance until a complete standard is issued in the future. Before IFRS, accounting practices varied greatly between national standard-setters, so it was important that, with more and more entities switching to IFRS, there was at least some IFRS guidance in the area. Since it had had to be specifically excluded from IAS 16 and IAS 38, the IASB developed and issued IFRS 6.

IFRS 6 is related to IAS 38's distinction between research and development phases, where research costs are expensed and development costs are capitalised. The problem is that the exploration for and evaluation of mineral resources is not quite research and not quite development – hence the need for IFRS 6.

2.2 Scope

The scope of IFRS 6 is intentionally very narrow. Entities must apply IFRS 6 to all exploration and evaluation expenditure incurred, but it does not address other aspects of their accounting.

Moreover, IFRS 6 only applies *after* the entity has obtained legal rights to explore in a specific area, but *before* extraction has been demonstrated to be both technically feasible and commercially viable.

NOT yet exploring for resources (eg no legal right) → No IFRS (usually expense)

Demonstrated technical feasibility and commercial viability → IAS 38

→ No IFRS (usually expense) → IFRS 6 → IAS 38

Time →

Key terms

Exploration and evaluation expenditures are expenditures incurred by an entity in connection with the exploration for and evaluation of mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.

Exploration and evaluation assets are exploration and evaluation expenditures recognised as assets in accordance with the entity's accounting policy.

Exploration for and evaluation of mineral resources is the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as the determination of the technical feasibility and commercial viability of extracting the mineral resource. *(IFRS 6)*

2.3 Recognition

Expenditure is recognised as an asset for IFRS 6 until the technical feasibility and commercial viability of extracting resources can be demonstrated. Note that this also means that the entity must have the necessary technical and financial means to extract the resources.

An entity can then choose its own accounting policy as long as it is line with IAS 8. Specifically, it must conform to IAS 8 paragraph 10, which states that **management should use its judgement** in developing an **accounting policy** that results in information that is **relevant** and **reliable**. After choosing their policy, entities must then **apply their policy consistently**.

Note that expenditure related to the **development** of mineral resources must not be recognised as exploration and evaluation assets under IFRS 6, as they come under IAS 38.

2.4 Measurement at recognition

At recognition, exploration and evaluation **assets must be measured at cost**.

The following are examples of expenditures an entity might incur in the initial measurement of exploration and evaluation assets:

(a) Acquisition of rights to explore
(b) Topographical geological, geochemical and geophysical studies
(c) Exploratory drilling
(d) Trenching
(e) Sampling
(f) Activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource

An entity should also recognise the cost of any obligations for removal and restoration, in line with IAS 37.

Exam focus point

The syllabus explicitly requires the ability to give examples of elements of cost that might be included in the initial recognition in the financial statements. It would be advisable to learn the above, non-exhaustive, list!

2.5 Example: Cost

Gold Diggers Co is a mining company currently exploring and evaluating the possibilities for extracting gold from the deserts of South Australia. It has incurred the following costs in the year ended 20X1.

	$'000
Legal expenses relating to acquisition of land in which exploration is to take place	15,000
Legal expenses relating to acquisition of right to explore land	12,000
Exploratory drilling costs	123,000
General administrative overheads allocated to exploration of land in S Australia	25,000
Costs of extracting gold	152,000

Which of the above costs may be capitalised as exploration and evaluation assets in accordance with IFRS 6?

Solution

The following costs **can** be capitalised in accordance with IFRS 6:

	$'000
Legal expenses relating to acquisition of right to explore land	12,000
Exploratory drilling costs	123,000

The following costs **cannot** be capitalised in accordance with IFRS 6:

	$'000
Legal expenses relating to acquisition of land in which exploration is to take place (*Note 1*)	15,000
General administrative overheads allocated to exploration of land in S Australia (*Note 2*)	25,000
Costs of extracting gold (*Note 3*)	152,000

Notes

1. The land is acquired before the process of exploration and evaluation beings (because by definition the entity cannot be exploring and evaluating resources on land it does not own). The legal expenses relating to the acquisition are therefore not accounted for in line with IFRS 6, and are expensed.
2. General administrative overheads do not relate to the exploration and evaluation of resources, and must be expensed.
3. The costs of extracting gold are incurred after the process of exploration and evaluation has ended, and are not therefore accounted for in accordance with IFRS 6. They are costs incurred in the ordinary course of the business, and will likely be expensed as they are unlikely to qualify as intangible assets under IAS 38.

2.6 Measurement after recognition

Entities must apply either the **cost model** or the **revaluation model** (taking the revaluation model either from IAS 16 or IAS 38).

2.7 Changes in accounting policies

These may be made if the change makes the financial statements more relevant to users. **IAS 8** criteria need to be applied.

2.8 Classification and reclassification

Exploration and evaluation assets are classified as **tangible or intangible according to the nature** of the assets acquired. For example, drilling rights would be intangible; vehicles or drilling rigs would be tangible. The classification must be applied consistently.

They should no longer be classified as exploration and evaluation assets when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Any impairment loss on the assets must be recognised before classification.

2.9 Impairment

Exploration and evaluation assets must be **assessed for impairment when facts and circumstances suggest that the carrying amount of an asset may exceed its recoverable amount. Any resulting impairment loss must be measured, presented and disclosed in accordance with IAS 36.**

The following **factors** suggest exploration and evaluation assets should be tested for impairment:

(a) The period for which the entity has **exploration rights has expired** or is due to expire in the near future and is not expected to be reviewed.

(b) **Substantive expenditure** on further exploration in the specific area is **not budgeted** or planned.

(c) Exploration in a specific area has **not** led to the discovery of **commercially viable quantities** of mineral resources, and the entity has decided to discontinue activities in this area.

(d) Sufficient data indicates that whilst a development in a specific area may proceed, the **carrying value of the exploration and evaluation asset is unlikely to be recovered** from successful development and sale.

For impairment purposes, each cash generating unit or group of units to which an exploration and evaluation asset is allocated must not be larger than a segment as determined by IFRS 8 *Operating segments.*

2.10 Disclosures

These must identify and explain the amounts recognised in the accounts. Specifically, entities must explain:

- Accounting policies
- The amounts of assets, liabilities, income and expenses, and operating and investing cash flows

Chapter Roundup

- IAS 41 applies the requirements of IFRS to the treatment of biological assets.
- In relation to agriculture you should be able to discuss:
  - Accounting for biological assets
  - Transformation and changes in substance
  - Unit of measurement and changes in the carrying amount
- In relation to government grants you should be able to explain treatment, presentation and disclosure.
- IFRS 6 requires that mineral resources at initial recognition are measured at cost.
  - Subsequent measurement may be based on either the **cost model** or the **revaluation model**.
  - Assets must be **tested for impairment** in accordance with IAS 36.

Quick Quiz

1 What is a biological asset?

2 What is agricultural produce?

3 Fill in the missing words.

Transformation refers to the .... transformation, whereby .... and .... undergo a change in .... quality and/or quantity over .... which is .... and monitored as part of .... control.

4 IAS 41 has abolished the concept of cost for measurement purposes. True/False?

5 An entity has just begun exploring a previously unexplored area of ocean for oil. It has discovered oil there and there is an active market to sell to. The entity is unsure, however, if it can raise the necessary funds to complete the exploration process. What is the required treatment of the exploration costs incurred?

Answers to Quick Quiz

1 A biological asset is a living animal or plant.

2 Agricultural produce is product harvested from biological assets.

3 Physical, animal, plants, biological, time, measured, management

4 False. Cost is still allowed if fair value is not available at initial recognition.

5 The costs are recognised as expenses in profit and loss, as the entity does not have the financial resources to bring any asset to market and to receive future benefits from it.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q18	Introductory	n/a	n/a

15

Share-based payment

Topic list	Syllabus reference
1 IFRS 2 *Share-based payment*	B13
2 Deferred tax implications	B13

Introduction

This chapter deals with IFRS 2 on share based payment, a controversial area. The material in this chapter relates to equity settled and cash settled transactions.

Study guide

B13	**Share-based payment**
(a)	Understand the term 'share-based payment'
(b)	Discuss the key issue that measurement of the transaction should be based on fair value
(c)	Explain the difference between cash-settled share-based payment transactions and equity-settled share-based payment transactions
(d)	Identify the principles applied to measuring both cash and equity settled share-based payment transactions
(e)	Compute the amounts that need to be recorded in the statement of profit or loss and other comprehensive income and the statement of financial position when an entity carries out a transaction where the payment is share based

1 IFRS 2 *Share-based payment*

FAST FORWARD

Share-based payment transactions should be recognised in the financial statements. You need to understand and be able to advise on:

- Recognition
- Measurement
- Disclosure

of both equity settled and cash settled transactions.

Exam focus point

Share-based payment is a popular exam topic and is examined in some way or another in almost every sitting. The June 2013 paper, for example, included it as part of question one; the December 2013 paper tested it as part of question four, for six marks.

1.1 Background

Transactions whereby entities purchase goods or services from other parties, such as suppliers and employees, by **issuing shares or share options** to those other parties are **increasingly common**. Share schemes are a common feature of director and executive remuneration and in some countries the authorities may offer tax incentives to encourage more companies to offer shares to employees. Companies whose shares or share options are regarded as a valuable 'currency' commonly use share-based payment to obtain employee and professional services.

The increasing use of share-based payment has raised questions about the accounting treatment of such transactions in company financial statements.

Share options are often granted to employees at an exercise price that is equal to or higher than the market price of the shares at the date the option is granted. Consequently, the options have no intrinsic value and so **no transaction is recorded in the financial statements**.

This leads to an **anomaly:** if a company pays its employees in cash, an expense is recognised in profit or loss, but if the payment is in share options, no expense is recognised.

1.1.1 Arguments against recognition of share-based payment in the financial statements

There are a number of arguments against recognition. The IASB has considered and rejected the following arguments.

(a) **No cost therefore no charge**

There is no cost to the entity because the granting of shares or options does not require the entity to sacrifice cash or other assets. Therefore, a charge should not be recognised.

This argument is unsound because it ignores the fact that a transaction has occurred. The employees have provided valuable services to the entity in return for valuable shares or options.

(b) **Earnings per share is hit twice**

It is argued that the charge to profit or loss for the employee services consumed reduces the entity's earnings, while at the same time there is an increase in the number of shares issued.

However, the dual impact on earnings per share simply reflects the two economic events that have occurred.

(i) The entity has issued shares or options, thus increasing the denominator of the earnings per share calculation.

(ii) It has also consumed the resources it received for those shares or options, thus reducing the numerator.

(c) **Adverse economic consequences**

It could be argued that entities might be discouraged from introducing or continuing employee share plans if they were required to recognise them on the financial statements. However, if this happened, it might be because the requirement for entities to account properly for employee share plans had revealed the economic consequences of such plans.

A situation where entities are able to obtain and consume resources by issuing valuable shares or options without having to account for such transactions could be perceived as a distortion.

1.2 Objective and scope

IFRS 2 requires an entity to **reflect the effects of share-based payment transactions** in its profit or loss and financial position.

IFRS 2 applies to all share-based payment transactions. There are three types.

(a) **Equity-settled share-based payment transactions**, in which the entity receives goods or services in exchange for equity instruments of the entity (including shares or share options)

(b) **Cash-settled share-based payment transactions**, in which the entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity

(c) Transactions in which the entity receives or acquires goods or services and either the entity or the supplier has a **choice** as to whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments

IFRS 2 was amended in 2009 to address situations in those parts of the world where, for public policy or other reasons, companies give their shares or rights to shares to individuals, organisations or groups that have not provided goods or services to the company. An example is the issue of shares to a charitable organisation for less than fair value, where the benefits are more intangible than usual goods or services.

1.2.1 Share-based payment among group entities

Payment for goods or services received by an entity within a group may be made in the form of granting equity instruments of the parent company, or equity instruments of another group company.

IFRS 2 states that this type of transaction qualifies as a share-based payment transaction within the scope of IFRS 2.

In 2009, the standard was amended to clarify that it applies to the following arrangements:

(a) Where the entity's suppliers (including employees) will receive cash payments that are linked to the price of the equity instruments of the entity

(b) Where the entity's suppliers (including employees) will receive cash payments that are linked to the price of the equity instruments of the entity's parent

Under either arrangement, the entity's parent had an obligation to make the required cash payments to the entity's suppliers. The entity itself did not have any obligation to make such payments. IFRS 2 applies to arrangements such as those described above even if the entity that receives goods or services from its suppliers has no obligation to make the required share-based cash payments.

1.2.2 Transactions outside the scope of IFRS 2

Certain transactions are **outside the scope** of the IFRS:

(a) Transactions with employees and others in their capacity as a holder of equity instruments of the entity (for example, where an employee receives additional shares in a rights issue to all shareholders)
(b) The issue of equity instruments in exchange for control of another entity in a business combination

Key term

Share-based payment transaction. A transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options), or acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of the entity's shares or other equity instruments of the entity.
Share-based payment arrangement. An agreement between the entity and another party (including an employee) to enter into a share-based payment transaction, which thereby entitles the other party to receive cash or other assets of the entity for amounts that are based on the price of the entity's shares or other equity instruments of the entity, or to receive equity instruments of the entity, provided the specified vesting conditions, if any, are met.

Equity instrument. A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Equity instrument granted. The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

Share option. A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

Fair value. The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction**.** (Note that this definition is different from that in IFRS 13 *Fair value measurement,* but the IFRS 2 definition applies.)

Grant date. The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement. At grant date the entity confers on the other party (the counterparty) the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), grant date is the date when that approval is obtained.

Intrinsic value. The difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the other party is (or will be) required to pay for those shares. For example, a share option with an exercise price of $15 on a share with a fair value of $20, has an intrinsic value of $5.

Key terms (cont'd)

Measurement date. The date at which the fair value of the equity instruments granted is measured. For transactions with employees and others providing similar services, the measurement date is the grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

Vest. To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets, or equity instruments of the entity vests upon satisfaction of any specified vesting conditions.

Vesting conditions. The conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement. Vesting conditions include service conditions, which require the other party to complete a specified period of service, and performance conditions, which require specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time).

Vesting period. The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

1.3 Vesting conditions

IFRS 2 recognises two types of vesting conditions:

Non-market based vesting conditions

These are conditions other than those relating to the market value of the entity's shares. Examples include vesting dependent on:

- The employee completing a minimum period of service (also referred to as a service condition)
- Achievement of minimum sales or earnings target
- Achievement of a specific increase in profit or earnings per share
- Successful completion of a flotation
- Completion of a particular project

Market based vesting conditions

Market-based performance or vesting conditions are conditions linked to the market price of the shares in some way. Examples include vesting dependent on achieving:

- A minimum increase in the share price of the entity
- A minimum increase in shareholder return
- A specified target share price relative to an index of market prices

The definition of vesting conditions is:

- Restricted to service conditions and performance conditions, and
- Excludes other features such as a requirement for employees to make regular contributions into a savings scheme.

1.4 Recognition: the basic principle

An entity should **recognise goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received**. Goods or services received or acquired in a share-based payment transaction **should be recognised as expenses unless they qualify for recognition as assets**. For example, services are normally recognised as expenses (because they are normally rendered immediately), while goods are recognised as assets.

If the goods or services were received or acquired in an **equity-settled** share-based payment transaction the entity should recognise **a corresponding increase in equity** (reserves).

If the goods or services were received or acquired in a **cash-settled** share-based payment transaction the entity should recognise a **liability**.

1.5 Equity-settled share-based payment transactions

1.5.1 Measurement

The issue here is how to measure the 'cost' of the goods and services received and the equity instruments (eg the share options) granted in return.

The general principle in IFRS 2 is that when an entity recognises the goods or services received and the corresponding increase in equity, it should measure these at the **fair value of the goods or services received**. Where the transaction is with **parties other than employees**, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably.

If the fair value of the goods or services received cannot be measured reliably, the entity should measure their value by reference to the **fair value of the equity instruments granted**.

Where the transaction is with a party other than an employee fair value should be measured at the date the entity obtains the goods or the counterparty renders service.

Where shares, share options or other equity instruments are granted to **employees** as part of their remuneration package, it is not normally possible to measure directly the services received. For this reason, the entity should measure the fair value of the employee services received by reference to the **fair value of the equity instruments granted**. The fair value of those equity instruments should be measured at the **grant date**.

1.5.2 Determining the fair value of equity instruments granted

Where a transaction is measured by reference to the fair value of the equity instruments granted, fair value is based on **market prices** if available, taking into account the terms and conditions upon which those equity instruments were granted.

If market prices are not available, the entity should estimate the fair value of the equity instruments granted using a **valuation technique**. (These are beyond the scope of this exam.)

1.5.3 Transactions in which services are received

The issue here is **when** to recognise the transaction. When equity instruments are granted they may vest immediately, but often the counterparty has to meet specified conditions first. For example, an employee may have to complete a specified period of service. This means that the effect of the transaction normally has to be allocated over more than one accounting period.

If the equity instruments granted **vest immediately**, (ie the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to the equity instruments) it is presumed that the services have already been received (in the absence of evidence to the contrary). The entity should **recognise the services received in full**, with a corresponding increase in equity, **on the grant date**.

If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity should account for those services **as they are rendered** by the counterparty during the vesting period. For example if an employee is granted share options on condition that he or she completes three years' service, then the services to be rendered by the employee as consideration for the share options will be received in the future, over that three-year vesting period.

The entity should recognise an amount for the goods or services received during the vesting period based on the **best available estimate** of the **number of equity instruments expected to vest**. It should **revise** that estimate if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On **vesting date**, the entity should revise the estimate to **equal the number of equity instruments that actually vest**.

Once the goods and services received and the corresponding increase in equity have been recognised, the entity should make no subsequent adjustment to total equity after vesting date.

1.6 Example: Equity-settled share-based payment transaction

On 1 January 20X1 an entity grants 100 share options to each of its 400 employees. Each grant is conditional upon the employee working for the entity until 31 December 20X3. The fair value of each share option is $20.

During 20X1 20 employees leave and the entity estimates that 20% of the employees will leave during the three-year period.

During 20X2 a further 25 employees leave and the entity now estimates that 25% of its employees will leave during the three-year period.

During 20X3 a further 10 employees leave.

Required

Calculate the remuneration expense that will be recognised in respect of the share-based payment transaction for each of the three years ended 31 December 20X3.

Solution

IFRS 2 requires the entity to recognise the remuneration expense, based on the fair value of the share options granted, as the services are received during the three-year vesting period.

In 20X1 and 20X2 the entity estimates the number of options expected to vest (by estimating the number of employees likely to leave) and bases the amount that it recognises for the year on this estimate.

In 20X3 it recognises an amount based on the number of options that actually vest. A total of 55 employees left during the three-year period and therefore 34,500 options ((400 – 55) × 100) vested.

The amount recognised as an expense for each of the three years is calculated as follows:

		Cumulative expense at year-end	*Expense for year*
		$	$
20X1	40,000 × 80% × 20 × 1/3	213,333	213,333
20X2	40,000 × 75% × 20 × 2/3	400,000	186,667
20X3	34,500 × 20	690,000	290,000

Question

Share options

During its financial year ended 31 January 20X6, TSQ issued share options to several of its senior employees. The options vest immediately upon issue.

Which *one* of the following describes the accounting entry that is required to recognise the options?

A	DEBIT the statement of changes in equity	CREDIT liabilities
B	DEBIT the statement of changes in equity	CREDIT equity
C	DEBIT profit or loss	CREDIT liabilities
D	DEBIT profit or loss	CREDIT equity

Answer

D Under IFRS 2 a charge must be made to the profit or loss.

Question — Share based payment 1

On 1 January 20X3 an entity grants 250 share options to each of its 200 employees. The only condition attached to the grant is that the employees should continue to work for the entity until 31 December 20X6. Five employees leave during the year.

The market price of each option was $12 at 1 January 20X3 and $15 at 31 December 20X3.

Required

Show how this transaction will be reflected in the financial statements for the year ended 31 December 20X3.

Answer

The remuneration expense for the year is based on the fair value of the options granted at the grant date (1 January 20X3). As five of the 200 employees left during the year it is reasonable to assume that 20 employees will leave during the four-year vesting period and that therefore 45,000 options (250 × 180) will actually vest.

Therefore, the entity recognises a remuneration expense of $135,000 (45,000 × 12 × ¼) in profit or loss and a corresponding increase in equity of the same amount.

Question — Share based payment 2

J&B granted 200 options on its $1 ordinary shares to each of its 800 employees on 1 January 20X1. Each grant is conditional upon the employee being employed by J&B until 31 December 20X3.

J&B estimated at 1 January 20X1 that:

(i) The fair value of each option was $4 (before adjustment for the possibility of forfeiture).

(ii) Approximately 50 employees would leave during 20X1, 40 during 20X2 and 30 during 20X3 thereby forfeiting their rights to receive the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was $1.50 and the market value of a J&B share on 1 January 20X1 was $3.

In the event, only 40 employees left during 20X1 (and the estimate of total departures was revised down to 95 at 31 December 20X1), 20 during 20X2 (and the estimate of total departures was revised to 70 at 31 December 20X2) and none during 20X3, spread evenly during each year.

Required

The directors of J&B have asked you to illustrate how the scheme is accounted for under IFRS 2 *Share-based payment*.

(a) Show the double entries for the charge to profit or loss for employee services over the three years and for the share issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X3.

(b) Explain how your solution would differ had J&B offered its employees cash based on the share value rather than share options.

Answer

(a) **Accounting entries**

		$	$
31.12.X1			
DEBIT	Profit or loss (Staff costs)	188,000	
CREDIT	Equity reserve ((800 – 95) × 200 × $4 × 1/3)		188,000
31.12.X2			
DEBIT	Profit or loss (Staff costs) (W1)	201,333	
CREDIT	Equity reserve		201,333
31.12.X3			
DEBIT	Profit or loss (Staff costs) (W2)	202,667	
CREDIT	Equity reserve		202,667
Issue of shares:			
DEBIT	Cash (740 × 200 × $1.50)	222,000	
DEBIT	Equity reserve	592,000	
CREDIT	Share capital (740 × 200 × $1)		148,000
CREDIT	Share premium (balancing figure)		666,000

Workings

1 *Equity reserve at 31.12.X2*

	$
Equity b/d	188,000
∴ P/L charge	201,333
Equity c/d ((800 – 70) × 200 × $4 × 2/3)	389,333

2 *Equity reserve at 31.12.X3*

Equity b/d	389,333
∴ P/L charge	202,667
Equity c/d ((800 – 40 – 20) × 200 × $4 × 3/3)	592,000

(b) **Cash-settled share-based payment**

If J&B had offered cash payments based on the value of the shares at vesting date rather than options, in each of the three years an accrual would be shown in the statement of financial position representing the expected amount payable based on the following:

No of employees estimated at the year end to be entitled to rights at the vesting date	×	Number of rights each	×	Fair value of each right at year end	×	Cumulative proportion of vesting period elapsed

The movement in the accrual would be charged to profit or loss representing further entitlements received during the year and adjustments to expectations accrued in previous years.

The accrual would continue to be adjusted (resulting in a profit or loss charge) for changes in the fair value of the right over the period between when the rights become fully vested and are subsequently exercised. It would then be reduced for cash payments as the rights are exercised.

1.7 Cancellation and reissuance

Where an entity has been through a capital restructuring or there has been a significant downturn in the equity market through external factors, an alternative to **re-pricing** the **share options** is to **cancel** them and issue new options based on revised terms. The end result is essentially the same as an entity modifying the original options and therefore should be recognised in the same way.

As well as the entity, two other parties may cancel an equity instrument:

- Cancellations by the counterparty (eg the employee)
- Cancellations by a third party (eg a shareholder)

Cancellations by the employee must be treated in the same way as cancellations by the employer, resulting in an **accelerated charge to profit or loss of the unamortised balance of the options granted**.

1.8 Cash-settled share-based payment transactions

Examples of this type of transaction include:

(a) **Share appreciation rights** granted to employees: the employees become entitled to a future cash payment (rather than an equity instrument), based on the increase in the entity's share price from a specified level over a specified period of time, or

(b) An entity might grant to its employees a right to receive a future cash payment by granting to them a **right to shares that are redeemable**.

The basic principle is that the entity measures the goods or services acquired and the liability incurred at the **fair value of the liability**.

The entity should **remeasure** the fair value of the liability **at each reporting date** until the liability is settled **and at the date of settlement**. Any **changes** in fair value are recognised in **profit or loss** for the period.

The entity should recognise the services received, and a liability to pay for those services, **as the employees render service.** For example, if share appreciation rights do not vest until the employees have completed a specified period of service, the entity should recognise the services received and the related liability, over that period.

1.9 Example: Cash-settled share-based payment transaction

On 1 January 20X1 an entity grants 100 cash share appreciation rights (SARS) to each of its 500 employees, on condition that the employees continue to work for the entity until 31 December 20X3.

During 20X1 35 employees leave. The entity estimates that a further 60 will leave during 20X2 and 20X3.

During 20X2 40 employees leave and the entity estimates that a further 25 will leave during 20X3.

During 20X3 22 employees leave.

At 31 December 20X3 150 employees exercise their SARs. Another 140 employees exercise their SARs at 31 December 20X4 and the remaining 113 employees exercise their SARs at the end of 20X5.

The fair values of the SARs for each year in which a liability exists are shown below, together with the intrinsic values at the dates of exercise.

	Fair value	*Intrinsic value*
	$	$
20X1	14.40	
20X2	15.50	
20X3	18.20	15.00
20X4	21.40	20.00
20X5		25.00

Required

Calculate the amount to be recognised in the profit or loss for each of the five years ended 31 December 20X5 and the liability to be recognised in the statement of financial position at 31 December for each of the five years.

Solution

For the three years to the vesting date of 31 December 20X3 the expense is based on the entity's estimate of the number of SARs that will actually vest (as for an equity-settled transaction). However, the fair value of the liability is **re-measured** at each year-end.

The intrinsic value of the SARs at the date of exercise is the amount of cash actually paid.

		Liability at year-end		*Expense for year*
		$	$	$
20X1	Expected to vest (500 – 95):			
	405 × 100 × 14.40 × 1/3	194,400		194,400
20X2	Expected to vest (500 – 100):			
	400 × 100 × 15.50 × 2/3	413,333		218,933
20X3	Exercised:			
	150 ×100 × 15.00		225,000	
	Not yet exercised (500 – 97 – 150):			
	253 × 100 × 18.20	460,460	47,127	
				272,127
20X4	Exercised:			
	140 × 100 × 20.00		280,000	
	Not yet exercised (253 – 140):			
	113 × 100 × 21.40	241,820	(218,640)	
				61,360
		$	$	$
20X5	Exercised:			
	113 × 100 × 25.00		282,500	
		Nil	(241,820)	
				40,680
				787,500

See Section 1.2.2 for a definition of intrinsic value.

1.10 Section summary

IFRS 2 requires entities to **recognise** the goods or services received as a result of **share based payment transactions**.

- Equity settled transactions: DEBIT Asset/Expense, CREDIT Equity
- Cash settled transactions: DEBIT Asset/Expense, CREDIT Liability
- Transactions are **recognised when goods/services are obtained/received** (usually over the performance period)
- Transactions are measured at fair value

2 Deferred tax implications

FAST FORWARD

An entity may receive a tax deduction that is different in timing or amount from the related expense.

2.1 Issue

An entity may receive a tax deduction that differs from related cumulative remuneration expense, and may arise in a later accounting period.

For example, an entity recognises an expense for share options granted under IFRS 2, but does not receive a tax deduction until the options are exercised and receives the tax deduction at the share price on the exercise date.

2.2 Measurement

The deferred tax asset temporary difference is measured as:

Carrying amount of share-based payment expense	0
Less: tax base of share-based payment expense (estimated amount tax authorities will permit as a deduction in future periods, based on year end information)	(X)
Temporary difference	(X)
Deferred tax asset at X%	X

If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates also to an equity item.

The excess is therefore recognised directly in equity.

2.3 Example: Deferred tax implications of share-based payment

On 1 January 20X2, Bruce granted 5,000 share options to an employee vesting two years later on 31 December 20X3. The fair value of each option measured at the grant date was $3.

Tax law in the jurisdiction in which the entity operates allows a tax deduction of the intrinsic value of the options on exercise. The intrinsic value of the share options was $1.20 at 31 December 20X2 and $3.40 at 31 December 20X3 on which date the options were exercised.

Assume a tax rate of 30%.

Required

Show the deferred tax accounting treatment of the above transaction at 31 December 20X2, 31 December 20X3 (before exercise), and on exercise.

Solution

	31/12/20X2	*31/12/20X3 before exercise*
Carrying amount of share-based payment expense	0	0
Less: Tax base of share-based payment expense (5,000 × $1.2 × ½)/(5,000 × $3.40)		(17,000)
Temporary difference	(3,000)	(17,000)
Deferred tax asset @ 30%	900	5,100
Deferred tax (Cr P/L) (5,100 – 900 – (Working) 600)	900	3,600
Deferred tax (Cr Equity) (Working)	0	600

On exercise, the deferred tax asset is replaced by a current tax one. The double entry is:

DEBIT Deferred tax (I/S)	4,500		reversal
DEBIT Deferred tax (equity)	600		
CREDIT Deferred tax asset		5,100	

DEBIT Current tax asset	5,100	
CREDIT Current tax (I/S)		4,500
CREDIT Current tax (equity)		600

Working

Accounting expense recognised (5,000 × $3 × ½)/(5,000 × $3)	7,500	15,000
Tax deduction	(3,000)	(17,000)
Excess temporary difference	0	(2,000)
Excess deferred tax asset to equity @ 30%	0	600

Chapter Roundup

- **Share-based payment** transactions should be recognised in the financial statements. You need to understand and be able to advise on:

  – Recognition
  – Measurement
  – Disclosure

  of both equity settled and cash settled transactions.

- An entity may receive a tax deduction that differs in timing or amount from the related expense.

Quick Quiz

1 What is a cash-settled share based payment transaction?

2 What is the grant date?

3 If an entity has entered into an equity settled share-based payment transaction, what should it recognise in its financial statements?

4 Where an entity has granted share options to its employees in return for services, how is the transaction measured?

Answers to Quick Quiz

1 A transaction in which the entity receives goods or services in exchange for amounts of cash that are based on the price (or value) of the entity's shares or other equity instruments of the entity.

2 The date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement.

3 The goods or services received and a corresponding increase in equity.

4 By reference to the fair value of the equity instruments granted, measured at grant date.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q19	Examination	20	36 mins

PART C

Presentation and additional disclosures

16

Presentation of published financial statements

Introduction

We begin in this chapter by looking at the overall **content and format** of company financial statements. These are governed by IAS 1 (revised) *Presentation of financial statements*. Note that IAS 1 has been revised several times, most recently in 2011.

Study guide

C1	**Presentation of the statement of profit or loss and other comprehensive income**
(a)	State the objectives of international accounting standards governing presentation of financial statements
(b)	Describe the structure and content of statements of financial position, statements of profit or loss and other comprehensive income including continuing operations
(c)	Discuss 'fair presentation' and the accounting concepts/principles
(d)	Recognise the content and format of interim financial statements

1 IAS 1 (revised) Presentation of financial statements

FAST FORWARD

IAS 1 covers the form and content of financial statements. The main components are:

– Statement of financial position
– Statement of profit or loss and other comprehensive income
– Statement of changes in equity
– Statement of cash flows
– Notes to the financial statements

1.1 Profit or loss for the year

The statement of profit or loss and other comprehensive income is the most significant indicator of a company's financial performance. So it is important to ensure that it is not misleading.

IAS 1 stipulates that all items of income and expense recognised in a period shall be included in profit or loss unless a **Standard** or an **Interpretation** requires otherwise.

Circumstances where items may be excluded from profit or loss for the current year include the correction of errors and the effect of changes in accounting policies. These are covered in IAS 8.

1.2 How items are disclosed

IAS 1 specifies disclosures of certain items in certain ways.

- Some items must appear on the face of the statement of financial position or statement of profit or loss and other comprehensive income
- Other items can appear in a **note to the financial statements** instead
- **Recommended formats** are given which entities may or may not follow, depending on their circumstances

Obviously, disclosures specified by **other standards** must also be made, and we will mention the necessary disclosures when we cover each statement in turn. Disclosures in both IAS 1 and other standards must be made either on the face of the statement or in the notes unless otherwise stated, ie disclosures cannot be made in an accompanying commentary or report.

1.3 Identification of financial statements

As a result of the above point, it is most important that entities **distinguish the financial statements** very clearly from any other information published with them. This is because all IASs/IFRSs apply *only* to the financial statements (ie the main statements and related notes), so readers of the annual report must be able to differentiate between the parts of the report which are prepared under IFRSs, and other parts which are not.

The entity should **identify each** financial statement and the notes very clearly. IAS 1 also requires disclosure of the following information in a prominent position. If necessary it should be repeated wherever it is felt to be of use to the reader in his understanding of the information presented.

- **Name** of the reporting entity (or other means of identification)
- Whether the accounts cover the **single entity** only or a group of entities
- The **date of the end of the reporting period** or the period covered by the financial statements (as appropriate)
- The **presentation currency**
- The **level of rounding** used in presenting amounts in the financial statements

Judgement must be used to determine the best method of presenting this information. In particular, the standard suggests that the approach to this will be very different when the financial statements are communicated electronically.

The **level of rounding** is important, as presenting figures in thousands or millions of units makes the figures more understandable. The level of rounding must be disclosed, however, and it should not obscure necessary details or make the information less relevant.

1.4 Reporting period

It is normal for entities to present financial statements **annually** and IAS 1 states that they should be prepared at least as often as this. If (unusually) the end of an entity's reporting period is changed, for whatever reason, the period for which the statements are presented will be less or more than one year. In such cases the entity should also disclose:

(a) the **reason(s) why** a period other than one year is used; and
(b) the fact that the comparative figures given **are not in fact comparable**.

For practical purposes, some entities prefer to use a period which **approximates to a year**, eg 52 weeks, and the IAS allows this approach as it will produce statements not materially different from those produced on an annual basis.

1.5 Timeliness

If the publication of financial statements is delayed too long after the reporting period, their usefulness will be severely diminished. An entity with consistently complex operations cannot use this as a reason for its failure to report on a timely basis. Local legislation and market regulation imposes specific deadlines on certain entities.

IAS 1 looks at the statement of financial position and statement of profit or loss and other comprehensive income. We will not give all the detailed disclosures as some are outside the scope of your syllabus. Instead we will look at a **'proforma' set of accounts** based on the Standard.

2 Statement of financial position

FAST FORWARD

IAS 1 suggests a format for the statement of financial position. Certain items are specified for **disclosure on the face of the financial statements**.

IAS 1 discusses the distinction between current and non-current items in some detail, as we shall see in the next section. First of all we can look at the **suggested format** of the statement of financial position (given in an appendix to the Standard) and then look at further disclosures required.

2.1 Statement of financial position example

The example given by IAS 1 is as follows.

XYZ GROUP – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER

	20X7	*20X6*
Assets	$'000	$'000
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity instruments	142,500	156,000
	901,620	945,460
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	564,880	578,740
Total assets	1,466,500	1,524,200
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	903,700	782,900
Non-controlling interest	70,050	48,600
Total equity	973,750	831,500
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	177,650	238,280
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	315,100	454,420
Total liabilities	492,750	692,700
Total equity and liabilities	1,466,500	1,524,200

IAS 1 (revised) specifies various items which must appear on the **face of the statement of financial position** as a minimum disclosure.

(a) Property, plant and equipment (Chapter 4)
(b) Investment property (Chapter 4)
(c) Intangible assets (Chapter 6)
(d) Financial assets (excluding amounts shown under (e), (h) and (i)) (Chapter 11)
(e) Investments accounted for using the equity method (Chapter 24)
(f) Biological assets (Chapter 14)
(g) Inventories (Chapter 8)
(h) Trade and other receivables
(i) Cash and cash equivalents (Chapter 20)
(j) Assets classified as held for sale under IFRS 5
(k) Trade and other payables
(l) Provisions (Chapter 9)
(m) Financial liabilities (other than (j) and (k))
(n) Current tax liabilities and assets as in IAS 12 (Chapter 12)

(o) Deferred tax liabilities and assets (Chapter 12)
(p) Liabilities included in disposal groups under IFRS 5
(q) Non-controlling interests (Chapter 24 and 25)
(r) Issued capital and reserves

We will look at these items in the chapters marked.

Any **other line items**, headings or sub-totals should be shown on the face of the statement of financial position when it is necessary for an understanding of the entity's financial position.

The example shown above is for illustration only (although we will follow the format in this Study Text). The IAS, however, does not prescribe the order or format in which the items listed should be presented. It simply states that they **must be presented separately** because they are so different in nature or function from each other.

Whether additional items are presented separately depends on judgements based on the assessment of the following factors.

(a) **Nature and liquidity of assets and their materiality**. Thus goodwill and assets arising from development expenditure will be presented separately, as will monetary/non-monetary assets and current/non-current assets.
(b) **Function within the entity.** Operating and financial assets, inventories, receivables and cash and cash equivalents are therefore shown separately.
(c) **Amounts, nature and timing of liabilities**. Interest-bearing and non-interest-bearing liabilities and provisions will be shown separately, classified as current or non-current as appropriate.

The standard also requires separate presentation where **different measurement bases** are used for assets and liabilities which differ in nature or function. According to IAS 16, for example, it is permitted to carry certain items of property, plant and equipment at cost or at a revalued amount.

2.2 Information presented either on the face of the statement of financial position or by note

Further **sub-classification** of the line items listed above should be disclosed either on the face of the statement of financial position or in the notes. The classification will depend upon the nature of the entity's operations. As well as each item being sub-classified by its nature, any amounts payable to or receivable from any **group company or other related party** should also be disclosed separately.

The sub-classification details will in part depend on the requirements of IFRSs. The size, nature and function of the amounts involved will also be important and the factors listed above should be considered. **Disclosures** will vary from item to item and IAS 1 gives the following examples.

(a) **Property, plant and equipment** are classified by class as described in IAS 16, *Property, plant and equipment*.
(b) **Receivables** are analysed between amounts receivable from trade customers, other members of the group, receivables from related parties, prepayments and other amounts
(c) **Inventories** are sub-classified, in accordance with IAS 2 *Inventories,* into classifications such as merchandise, production supplies, materials, work in progress and finished goods
(d) **Provisions** are analysed showing separately provisions for employee benefit costs and any other items classified in a manner appropriate to the entity's operations
(e) **Equity capital and reserves** are analysed showing separately the various classes of paid in capital, share premium and reserves

The standard then lists some **specific disclosures** which must be made, either on the face of the statement of financial position or in the related notes.

(a) **Share capital disclosures (**for each class of share capital)

  (i) Number of shares authorised
  (ii) Number of shares issued and fully paid, and issued but not fully paid
  (iii) Par value per share, or that the shares have no par value

(iv) Reconciliation of the number of shares outstanding at the beginning and at the end of the year
(v) Rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital
(vi) Shares in the entity held by the entity itself or by related group companies
(vii) Shares reserved for issuance under options and sales contracts, including the terms and amounts

(b) Description of the nature and purpose of **each reserve** within owners' equity

Some types of entity have no share capital, eg partnerships. Such entities should disclose information which is **equivalent** to that listed above. This means disclosing the movement during the period in each category of equity interest and any rights, preferences or restrictions attached to each category of equity interest.

3 The current/non-current distinction

FAST FORWARD

You should appreciate the distinction between current and non-current assets and liabilities and their different treatments.

3.1 The current/non-current distinction

An entity must present **current** and **non-current** assets as separate classifications on the face of the statement of financial position. A presentation based on liquidity should only be used where it provides more relevant and reliable information, in which case all assets and liabilities must be presented broadly **in order of liquidity**.

In either case, the entity should disclose any portion of an asset or liability which is expected to be recovered or settled **after more than twelve months**. For example, for an amount receivable which is due in instalments over 18 months, the portion due after more than twelve months must be disclosed.

The IAS emphasises how helpful information on the **operating cycle** is to users of financial statements. Where there is a clearly defined operating cycle within which the entity supplies goods or services, then information disclosing those net assets that are continuously circulating as **working capital** is useful.

This distinguishes them from those net assets used in the long-term operations of the entity. Assets that are expected to be realised and liabilities that are due for settlement within the operating cycle are therefore highlighted.

The liquidity and solvency of an entity is also indicated by information about the **maturity dates** of assets and liabilities. As we will see later, IFRS 7 *Financial instruments: disclosures* requires disclosure of maturity dates of both financial assets and financial liabilities. (Financial assets include trade and other receivables; financial liabilities include trade and other payables.)

3.2 Current assets

Key term

An asset should be classified as a **current asset** when it:

- is expected to be realised in, or is held for sale or consumption in, the normal course of the entity's operating cycle; or
- is held primarily for trading purposes or for the short-term and expected to be realised within twelve months of the end of the reporting period; or
- is cash or a cash equivalent asset which is not restricted in its use.

All other assets should be classified as non-current assets. *(IAS 1)*

Non-current assets includes tangible, intangible, operating and financial assets of a long-term nature. Other terms with the same meaning can be used (eg 'fixed', 'long-term').

The term 'operating cycle' has been used several times above and the standard defines it as follows.

Key term

> The **operating cycle** of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. *(IAS 1)*

Current assets therefore include inventories and trade receivables that are sold, consumed and realised as part of the normal operating cycle. **This is the case even where they are not expected to be realised within twelve months**.

Current assets will also include **marketable securities** if they are expected to be realised within twelve months after the reporting period. If expected to be realised later, they should be included in non-current assets.

3.3 Current liabilities

Key term

> A liability should be classified as a **current liability** when it:
>
> - is expected to be settled in the normal course of the entity's operating cycle; or
> - is held primarily for the purpose of trading; or
> - is due to be settled within twelve months after the end of the reporting period; or when
> - The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the end of the reporting period.
>
> All other liabilities should be classified as non-current liabilities. *(IAS 1)*

The categorisation of current liabilities is very similar to that of current assets. Thus, some current liabilities are part of the **working capital** used in the normal operating cycle of the business (ie trade payables and accruals for employee and other operating costs). Such items will be classed as current liabilities **even where they are due to be settled more than twelve months after the end of the reporting period.**

There are also current liabilities which are not settled as part of the normal operating cycle, but which are due to be settled within twelve months of the end of the reporting period. These include bank overdrafts, income taxes, other non-trade payables and the current portion of interest-bearing liabilities. Any interest-bearing liabilities that are used to finance working capital on a long-term basis, and that are not due for settlement within twelve months, should be classed as **non-current liabilities**.

A **non-current financial liability** due to be **settled within twelve months** of the end of the reporting period should be classified as a **current liability**, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the end of the reporting period and before the financial statements are authorised for issue.

End of the reporting period	Agreement to refinance on long-term basis	Date financial statements authorised for issue	Settlement date <12 months after end of the reporting period therefore current liability

A **non-current financial liability** that is payable on **demand** because the entity **breached** a **condition** of its loan agreement should be classified as **current** at the end of the reporting period even if the **lender** has agreed **after the end of the reporting period**, and **before** the financial statements are **authorised for issue**, **not** to **demand payment** as a consequence of the breach.

Condition of loan agreement breached. Non-current liability becomes payable on demand	End of the reporting period	Lender agrees not to enforce payment resulting from breach	Date financial statements are authorised for issue. Loan shown as **current** liability

However, if the **lender** has **agreed** by the **end of the reporting period** to provide a **period of grace** ending **at least twelve months after the end of the reporting period** within which the entity can rectify the breach and during that time the lender cannot demand immediate repayment, the liability is classified as **non-current.**

4 Statement of profit or loss and other comprehensive income

FAST FORWARD

In June 2011 the IASB published an amendment to IAS 1 called 'Presentation of items of other comprehensive income'. This changed the name of the 'statement of comprehensive income' to the 'statement of profit or loss and other comprehensive income'.

4.1 Format

IAS 1 (revised) allows income and expense items to be presented either:

(a) in a single statement of profit or loss and other comprehensive income; or
(b) in two statements: a separate statement of profit or loss and statement of other comprehensive income.

The format for a single statement of profit or loss and other comprehensive income is shown as follows in the standard. The section down to 'profit for the year' can be shown as a separate 'statement of profit or loss' with an additional 'statement of other comprehensive income'. Note that not all of the items which would appear under 'other comprehensive income' are included in your syllabus.

Exam focus point

In the examinations, if a 'statement of profit or loss and other comprehensive income' is referred to, this will always relate to the single statement format. If 'statements of profit or loss' are referred to, this relates to the statement from 'revenue' to 'profit for the year'. Exams may refer to 'other comprehensive income' which relates to the 'other comprehensive income' section of the statement. In practice, the item of 'other comprehensive income' you are most likely to meet is a revaluation gain. Where we have used 'statement of profit or loss' in this text, this can be taken to refer to the profit or loss section of the full statement or separate statement of profit or loss.

XYZ GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7	*20X6*
	$'000	$'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Remeasurement gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain(loss) on property revaluation of associates	400	(700)
Income tax relating to items that will not be reclassified	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss		
Exchange differences on translating foreign operations	5,334	10,667
Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
Total comprehensive income for the year	107,250	93,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interest	24,250	13,100
	121,250	65,500
Total comprehensive income attributable to		
Owners of the parent	85,800	74,800
Non-controlling interest	21,450	18,700
	107,250	93,500
Earnings per share (in currency units)	0.46	0.30

This is the full statement as issued by the IASB.

Note that the amendment to IAS 1 now splits items of other comprehensive income into those which can be reclassified to profit or loss and those which can not be reclassified.

Companies are given the option of presenting this information in two statements as follows:

XYZ GROUP – STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7	*20X6*
	$'000	$'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
Profit for the year	121,250	65,500
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interest	24,250	13,100
	121,250	65,500

XYZ GROUP STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7 (TWO STATEMENT FORMAT)

	20X7	*20X6*
	$'000	$'000
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Actuarial gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain(loss) on property revaluation of associates	400	(700)
Income tax relating to items that will not be reclassified	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified to profit or loss:		
*Exchange differences on translating foreign operations	5,334	10,667
*Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
Total comprehensive income for the year	107,250	93,500
Total comprehensive income attributable to		
Owners of the parent	85,800	74,800
Non-controlling interest	21,450	18,700
	107,250	93,500

5 Statement of profit or loss

FAST FORWARD

IAS 1 offers **two** possible formats for the statement of profit or loss or separate profit or loss section – by **function or by nature**. Classification by function is more common.

5.1 Examples of separate statements of profit or loss

XYZ GROUP
STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

Illustrating the classification of expenses by function

	20X8	*20X7*
	$'000	$'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

Illustrating the classification of expenses by nature

	20X8	*20X7*
	$'000	$'000
Revenue	X	X
Other operating income	X	X
Changes in inventories of finished goods and work in progress	(X)	X
Work performed by the entity and capitalised	X	X
Raw material and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation and amortisation expense	(X)	(X)
Impairment of property, plant and equipment	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

Note: The usual method of presentation is expenses by function and this is the format likely to appear in your exam.

5.2 Information presented in the statement of profit or loss

The standard lists the following as the **minimum** to be disclosed on the face of the statement of profit or loss.

(a) Revenue
(b) Finance costs
(c) Share of profits and losses of associates and joint ventures accounted for using the equity method
(d) Pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to discontinued operations
(e) Tax expense
(f) Profit or loss

The following items must be disclosed as allocations of profit or loss for the period.

(a) Profit or loss attributable to non-controlling interest
(b) Profit or loss attributable to owners of the parent

The allocated amounts must not be presented as items of income or expense. (These relate to group accounts, covered later in this text.)

Income and expense items can only be **offset** when, and only when:

(a) It is permitted or required by an IFRS, or
(b) Gains, losses and related expenses arising from the same or similar transactions and events are immaterial, in which case they can be aggregated.

5.3 Information presented either in the statement or in the notes

An analysis of expenses must be shown either in the profit or loss section (as above, which is encouraged by the standard) or by note, using a classification based on *either* the nature of the expenses or their function. This **sub-classification of expenses** indicates a range of components of financial performance; these may differ in terms of stability, potential for gain or loss and predictability.

5.3.1 Nature of expense method

Expenses are not reallocated amongst various functions within the entity, but are aggregated in the statement of profit or loss **according to their nature** (eg purchase of materials, depreciation, wages and salaries, transport costs). This is by far the easiest method, especially for smaller entities.

5.3.2 Function of expense/cost of sales method

You are likely to be more familiar with this method. Expenses are classified according to their function as part of cost of sales, distribution or administrative activities. This method often gives **more relevant information** for users, but the allocation of expenses by function requires the use of judgement and can be arbitrary. Consequently, perhaps, when this method is used, entities should disclose **additional information** on the nature of expenses, including staff costs, and depreciation and amortisation expense.

Which of the above methods is chosen by an entity will depend on **historical and industry factors**, and also the **nature of the organisation**. Under each method, there should be given an indication of costs which are likely to vary (directly or indirectly) with the level of sales or production. The choice of method should fairly reflect the main elements of the entity's performance. **This is the method you should expect to see in your exam**.

5.4 Dividends

IAS 1 also requires disclosure of the amount of **dividends paid** during the period covered by the financial statements. This is shown either in the statement of changes in equity or in the notes.

Further points

(a) All requirements previously set out in other Standards for the presentation of particular line items in the statement of financial position and statement of profit or loss and other comprehensive income are now dealt with in IAS 1. These line items are: biological assets; liabilities and assets for current tax and deferred tax; and pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to discontinued operations.

(b) An entity must disclose, in the summary of significant accounting policies and/or other notes, the **judgements** made by management in **applying** the **accounting policies** that have the **most significant effect** on the amounts of items recognised in the financial statements.

(c) An entity must disclose in the notes information regarding **key assumptions** about the **future**, and other sources of **measurement uncertainty**, that have a significant **risk of** causing a **material adjustment** to the carrying amounts of assets and liabilities within the **next financial year**.

6 Revision of basic accounts

In the next part of this text we move on to the mechanics of preparing financial statements. It would be useful at this point to refresh your memory of the basic accounting you have already studied and these questions will help you. Make sure that you understand everything before you go on.

Point to note

The questions in this section are introductory rather than exam-standard.

Question

Basics

A friend has bought some shares in a company quoted on a local stock exchange and has received the latest accounts. There is one page he is having difficulty in understanding.

Required

Briefly, but clearly, answer his questions.

(a) What is a statement of financial position?
(b) What is an asset?
(c) What is a liability?
(d) What is share capital?
(e) What are reserves?
(f) Why does the statement of financial position balance?
(g) To what extent does the statement of financial position value my investment?

Answer

(a) A **statement of financial position** is a statement of the assets, liabilities and capital of a business as at a stated date. It is laid out to show either total assets as equivalent to total liabilities and capital or net assets as equivalent to capital. Other formats are also possible but the top half (or left hand) total will always equal the bottom half (or right hand) total.

(b) An **asset** is a resource controlled by a business and is expected to be of some future benefit. Its value is determined as the historical cost of producing or obtaining it (unless an attempt is being made to reflect rising prices in the accounts, in which case a replacement cost might be used). Examples of assets are:

  (i) Plant, machinery, land and other **non-current assets**

  (ii) **Current** assets such as inventories, cash and debts owed to the business with reasonable assurance of recovery: these are assets which are not intended to be held on a continuing basis in the business

(c) A **liability** is an amount owed by a business, other than the amount owed to its proprietors (capital). Examples of liabilities are:

(i) Amounts owed to the government (sales or other taxes)
(ii) Amounts owed to suppliers
(iii) Bank overdraft
(iv) Long-term loans from banks or investors

It is usual to differentiate between 'current' and 'long-term' liabilities. The former fall due within a year of the end of the reporting period.

(d) **Share capital** is the permanent investment in a business by its owners. In the case of a limited company, this takes the form of *shares* for which investors subscribe on formation of the company. Each share has a **nominal** or **par** (ie face) **value** (say $1). In the statement of financial position, total issued share capital is shown at its par value.

(e) If a company issues shares for more than their par value (at a **premium**) then (usually) by law this premium must be recorded separately from the par value in a 'share premium account'. This is an example of a reserve. It belongs to the shareholders but cannot be distributed to them, because it is a **capital reserve**. Other capital reserves include the revaluation surplus, which shows the surpluses arising on revaluation of assets which are still owned by the company.

Share capital and capital reserves are not distributable except on the winding up of the company, as a guarantee to the company's creditors that the company has enough assets to meet its debts. This is necessary because shareholders in limited liability companies have 'limited liability'; once they have paid the company for their shares they have no further liability to it if it becomes insolvent. The proprietors of other businesses are, by contrast, personally liable for business debts.

Retained earnings constitute accumulated profits (less losses) made by the company and can be distributed to shareholders as **dividends**. They too belong to the shareholders, and so are a claim on the resources of the company.

(f) Statements of financial position do not always balance on the first attempt, as all accountants know! However, once errors are corrected, all statements of financial position balance. This is because in **double entry bookkeeping** every transaction recorded has a dual effect. Assets are always equal to liabilities plus capital and so capital is always equal to assets less liabilities. This makes sense as the owners of the business are entitled to the net assets of the business as representing their capital plus accumulated surpluses (or less accumulated deficit).

(g) The statement of financial position is not intended as a statement of a business's worth at a given point in time. This is because, except where some attempt is made to adjust for the effects of rising prices, assets and liabilities are recorded at **historical cost** and on a prudent basis. For example, if there is any doubt about the recoverability of a debt, then the value in the accounts must be reduced to the likely recoverable amount. In addition, where non-current assets have a finite useful life, their cost is gradually written off to reflect the use being made of them.

Sometimes non-current assets are **revalued** to their market value but this revaluation then goes out of date as few assets are revalued every year.

The figure in the statement of financial position for capital and reserves therefore bears **no relationship** to the market value of shares. Market values are the product of a large number of factors, including general economic conditions, alternative investment returns (eg interest rates), likely future profits and dividends and, not least, market sentiment.

The accountant of Fiddles Co, a limited liability company, has begun preparing final accounts but the work is not yet complete. At this stage the items included in the list of account balances are as follows.

	$'000
Land	100
Buildings	120
Plant and machinery	170
Depreciation provision	120
Ordinary shares of $1	100
Retained earnings brought forward	380
Trade accounts receivable	200
Trade accounts payable	110
Inventory	190
Profit before tax	80
Allowance for receivables	3
Bank balance (asset)	12
Suspense	1

Notes (i) to (v) below are to be taken into account.

(i) The accounts receivable control account figure, which is used in the list of account balances, does not agree with the total of the sales ledger. A contra of $5,000 has been entered correctly in the individual ledger accounts but has been entered on the wrong side of both control accounts.

A batch total of sales of $12,345 had been entered in the double entry system as $13,345, although the individual ledger accounts entries for these sales were correct. The balance of $4,000 on the sales returns account has inadvertently been omitted from the trial balance though correctly entered in the ledger records.

(ii) A standing order of receipt from a regular customer for $2,000, and bank charges of $1,000, have been completely omitted from the records.

(iii) A receivable for $1,000 is to be written off. The allowance for receivables balance is to be adjusted to 1% of receivables.

(iv) The opening inventory figure had been overstated by $1,000 and the closing inventory figure had been understated by $2,000.

(v) Any remaining balance on the suspense account should be treated as purchases if a debit balance and as sales if a credit balance.

Required

(a) Prepare journal entries to cover items in notes (i) to (v) above. You are not to open any new accounts and may use only those accounts included in the list of account balances as given.

(b) Prepare final accounts for internal use within the limits of the available information. For presentation purposes all the items arising from notes (i) to (v) above should be regarded as material.

Answer

(a) JOURNAL ENTRIES FOR ADJUSTMENTS

		Debit	Credit
		$	$
(i)	Trade accounts payable	10,000	
	Trade accounts receivable		10,000
	Profit before tax	1,000	
	Trade accounts receivable		1,000
	Profit before tax	4,000	
	Suspense		4,000
(ii)	Bank	2,000	
	Trade accounts receivable		2,000
	Profit before tax	1,000	
	Bank		1,000
(iii)	Profit before tax	1,000	
	Trade accounts receivable		1,000
	Allowance for receivables (W1)	1,140	
	Profit before tax		1,140
(iv)	Inventories	2,000	
	Profit before tax		2,000
	Retained earnings brought forward	1,000	
	Profit before tax		1,000
(v)	Suspense	3,000	
	Profit before tax		3,000

(b) FIDDLES CO
STATEMENT OF FINANCIAL POSITION

	$	$	$
Assets			
Non-current assets			
Land and buildings		220,000	
Plant and machinery		170,000	
Depreciation		(120,000)	
			270,000
Current assets			
Inventories (190 + 2)		192,000	
Accounts receivable (W1)	186,000		
Less allowance	(1,860)		
		184,140	
Bank (12 + 2 – 1)		13,000	
			389,140
Total assets			659,140
Equity and liabilities			
Equity			
Share capital		100,000	
Retained earnings (see profit or loss)		459,140	
			559,140
Current liabilities			
Accounts payable (110 – 10)			100,000
Total equity and liabilities			659,140

FIDDLES CO
STATEMENT OF PROFIT OR LOSS (**Note**: this is not as per IAS 1, it is purely for internal purposes)

	$
Profit before tax (W2)	80,140
Retained earnings brought forward ($380,000 – 1,000)	379,000
Retained earnings carried forward	459,140

Workings

1 *Accounts receivable*

	$
Per opening trial balance	200,000
Contra	(10,000)
Miscasting	(1,000)
Standing order	(2,000)
Written off	(1,000)
	186,000
Allowance b/f	3,000
Allowance required	1,860
Journal	1,140

2 *Profit before tax*

	$
Per question	80,000
Wrong batch total	(1,000)
Returns	(4,000)
Bank charges	(1,000)
Irrecoverable debt	(1,000)
Allowance for receivables	1,140
Inventory (2,000 + 1,000)	3,000
Suspense (sales)	3,000
	80,140

Note: This question dealt with accounts for **internal** purposes. In accounts produced for publication the statement of profit or loss would comply with the IAS 1 format. In the following chapter we will be dealing with all the issues involved in producing financial statements for publication.

7 Changes in equity

FAST FORWARD

IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.

7.1 Format

This is the format of the statement of changes in equity as per IAS 1.

XYZ GROUP – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	*Retained earnings*	*Investments in equity instruments*	*Revaluation surplus*	*Total*	*Non-controlling interest*	*Total equity*
	$'000	$'000	$'000	$'000	$'000	$'000	$'000
Balance at 1 January 20X6	600,000	118,100	1,600	–	719,700	29,800	749,500
Changes in accounting policy	–	400	–	–	400	100	500
Restated balance	600,000	118,500	1,600	–	720,100	29,900	750,000
Changes in equity							
Dividends	–	(10,000)	–	–	(10,000)	–	(10,000)
Total comprehensive income for the year	–	53,200	16,000	1,600	70,800	18,700	89,500
Balance at 31 December 20X6	600,000	161,700	17,600	1,600	780,900	48,600	829,500
Changes in equity for 20X7							
Issue of share capital	50,000	–	–	–	50,000	–	50,000
Dividends	–	(15,000)	–	–	(15,000)	–	(15,000)
Total comprehensive income for the year	–	96,600	(14,400)	800	83,000	21,450	104,450
Transfer to retained earnings	–	200	–	(200)	–	–	–
Balance at 31 December 20X7	650,000	243,500	3,200	2,200	898,900	70,050	968,950

Note that where there has been a change of accounting policy necessitating a retrospective restatement, the adjustment is disclosed for each period. So, rather than just showing an adjustment to the balance b/f on 1.1.X7, the balances for 20X6 are restated.

A consolidated statement of changes in equity in the Dip IFR exam would be likely to look like this:

	Equity attributable to owners of the parent	*Non-controlling interest*	*Total*
	$'000	$'000	$'000
Balance at 1 Jan 20X9	X	X	X
Total comprehensive income for the year	X	X	X
Dividends	(X)	(X)	(X)
Balance at 31 Dec 20X9	X	X	X

The figures in the statement involve no new calculations. They are worked out as follows:

(a) The opening and closing balances of equity attributable to owners of the parent are calculated by adding together the parent share capital and the group reserves balance calculated using the workings you have prepared for consolidated statement of position examples.

(b) The opening and closing non-controlling interest balances are also calculated using the workings you have seen in the context of the statement of financial position.

(c) The figures for total comprehensive income are taken from the reconciliation at the end of the statement of profit or loss and other comprehensive income.

(d) The dividend shown in equity attributable to owners of the parent is the dividend paid by the parent.

(e) The dividend shown in the non-controlling interest column is the non-controlling interest share of the dividend paid by the subsidiary.

Question

Delta Group is preparing its financial statements for the year ended 31 March 20X1. Using the following information, prepare the group statement of changes in equity along with relevant extracts from the statement of financial position.

STATEMENT OF FINANCIAL POSITION (EXTRACT) OF DELTA GROUP AS AT 31 MARCH 20X0

Equity and liabilities	
Equity	
Share capital	90,000
Retained earnings	40,000
Total equity	130,000
Non-controlling interest	25,000
	155,000

(a) On 1 April 20X0 a bond was issued carrying a zero interest rate but redeemable at an amount of $16,105,100 on 31 March 20X5. The total proceeds for the issue were $12m. As an alternative to redemption, the bond-holders have the option to convert the bond into equity shares. Had the option not been available, the bond-holders would have only been prepared to invest $10 million given their requirement for a 10% return on their investment.

(b) The total divided paid in the year to ordinary shareholders was $20m.

(c) The group's total comprehensive income for the year was $10m, of which $0.5m is attributable to the non-controlling interest.

Answer

STATEMENT OF CHANGES IN EQUITY OF DELTA GROUP FOR THE YEAR ENDED 31 MARCH 20X1

	Share capital	*Other reserves*	*Retained earnings*	*Total*	*Non-controlling interest*	*Total equity*
	$'000	$'000	$'000	$'000	$'000	$'000
Balance at 31 March 20X0	90,000	-	40,000	130,000	25,000	155,000
Total comprehensive income for the year			9,500	9,500	500	10,000
Dividend paid			(20,000)	(20,000)	-	(20,000)
Equity element of convertible bond (*Working*)		2,000		2,000		2,000
Balance at 31 March 20X1	90,000	2,000	29,500	121,500	25,500	147,000

STATEMENT OF FINANCIAL POSITION (EXTRACT) OF DELTA GROUP FOR THE YEAR ENDED 31 MARCH 20X1

Equity and liabilities	
Equity	
Share capital	90,000
Retained earnings	29,500
Other reserves	2,000
Total equity	121,500
Non-controlling interest	25,500
	147,000

Working: equity and debt elements of convertible bond

	$'000
Total proceeds from redeemable debt	12,000
Less: loan element of convertible	10,000
Equity element	2,000

Question — Statement of changes in equity II

The following information relates to the Brodick Group for the year ended 30 April 20X7.

BRODICK GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR TO 30 APRIL 20X7

	$'000
Sales revenue (1,100 + 500)	1,600
Cost of sales (630 + 300)	(930)
Gross profit	670
Administrative expenses (105 + 150)	(255)
Profit before tax	415
Income tax expense (65 + 10)	(75)
Profit for the year	340
Other comprehensive income (not re-classified to P/L)	
Gain on property revaluation (100 + 200)	300
Total comprehensive income for the year	640

Profit attributable to:

	$'000
Owners of the parent (340 – 8)	332
Non-controlling interest (W1)	8
	340

Total comprehensive income attributable to:

	$'000
Owners of the parent (balancing figure)	592
Non-controlling interest (240 × 20%)	48
	640

Further information relating to Brodick Co and its subsidiary Lamlash Co for the year to 30 April 20X7:

	Brodick	*Lamlash*
	$'000	$'000
Dividends paid	200	30
Reserves brought forward	360	105
Reserves carried forward	584	315

(a) The issued share capital of the group was as follows.
Brodick Co: 5,000,000 ordinary shares of $1 each.
Lamlash Co: 1,000,000 ordinary shares of $1 each.

(b) Brodick Co purchased 80% of the issued share capital of Lamlash Co in 20X0. At that time, the revenue reserves of Lamlash amounted to $50,000. Neither company had any balance on the revaluation surplus until the current year.

(c) It is the group's policy to value NCI on acquisition at its proportionate share of the subsidiary's net assets.

Required
Prepare the Brodick group consolidated statement of changes in equity for the year to 30 April 20X7.

Answer

BRODICK GROUP
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR TO 30 APRIL 20X7

	Equity attributable to owners of the parent	*Non-controlling interest*	*Total*
	$'000	$'000	$'000
Balance at 1 Jan 20X6 (W1)/(W2)	5,404	221	5,625
Total comprehensive income for the year (W5)	592	48	640
Dividends (W6)	(200)	(6)	(206)
Balance at 31 Dec 20X7 (W3)/(W4)	5,796	263	6,059

Workings

1 Equity attributable to owners of the parent b/fwd

	Brodick	*Lamlash*
	$'000	$'000
Reserves per question	360	105
Less pre- acquisition		(50)
		55
Group share of S (55 × 80%)	44	
Group reserves b/fwd	404	
Add: share capital (Brodick only)	5,000	
Equity attributable to owners of the parent b/fwd	5,404	

Note: This working is exactly the same as that used to calculate retained earnings for the consolidated statement of financial position, but with an extra stage at the end to add on the parent's share capital which also forms part of **equity**.

2 *Non-controlling interest b/fwd*

	$
NCI at acquisition (20% × (1,000 + 50))	210
NCI share of L's post acquisition reserves (20% × 55 (W1))	11
NCI b/fwd	221

This working is exactly the same as that used in connection with the consolidated statement of financial position. The non-controlling interest at acquisition would normally be part of the goodwill working. Here, it has been calculated by applying the NCI % to the total of share capital and pre-acquisition reserves of Lamlash.

3 *Equity attributable to owners of the parent c/fwd*

	Brodick	*Lamlash*
	$'000	$'000
Retained earnings c/fwd per question	584	315
Less pre- acquisition		(50)
		265
Group share of S (265 × 80%)	212	
Group reserves c/fwd	796	
Add: share capital (Brodick only)	5,000	
Equity attributable to owners of the parent c/fwd	5,796	

Note: This working operates in exactly the same way as working 1, but using the closing reserves balances of the two companies. Notice also that there is no need to separate out the revaluation reserves that exist in both companies, as the statement of changes in equity layout that you need to use in the exam combines all of the reserves and share capital into one figure.

4 *Non-controlling interest c/fwd*

	$
NCI at acquisition (W2)	210
NCI share of L's post acquisition reserves (20% × 265 (W3))	53
NCI c/fwd	263

This working operates in exactly the same way as working (2), but using the non-controlling interests' share of the subsidiary's post acquisition reserves up to the end of the year.

5 The figures for total comprehensive income are taken from the reconciliation at the end of the statement of total comprehensive income

6 The dividend deducted from equity attributable to owners of the parent is the dividend paid by Brodick. The dividend in the non-controlling interest column is the non-controlling interest share of the dividend paid by Lamlash. (30 × 20%)

8 Notes to the financial statements

FAST FORWARD

Some items need to be disclosed by way of a note.

8.1 Contents of notes

The notes to the financial statements will **amplify** the information given in the statement of financial position, statement of profit or loss and other comprehensive income and statement of changes in equity. We have already noted above the information which the IAS allows to be shown by note rather than in the statements. To some extent, then, the contents of the notes will be determined by the level of detail shown on the **face of the statements**.

8.2 Structure

The notes to the financial statements should perform the following functions.

(a) Provide information about the **basis on which the financial statements were prepared** and which **specific accounting policies** were chosen and applied to significant transactions/events

(b) Disclose any information, not shown elsewhere in the financial statements, which is **required by IFRSs**

(c) Show any additional information that is relevant to understanding which is not shown elsewhere in the financial statements

The way the notes are presented is important. They should be given in a **systematic manner** and **cross referenced** back to the related figure(s) in the statement of financial position, statement of profit or loss and other comprehensive income, or statement of cash flows.

Notes to the financial statements will amplify the information shown therein by giving the following.

(a) More **detailed analysis** or breakdowns of figures in the statements
(b) **Narrative information** explaining figures in the statements
(c) **Additional information**, eg contingent liabilities and commitments

IAS 1 suggests a **certain order** for notes to the financial statements. This will assist users when comparing the statements of different entities.

(a) Statement of **compliance** with IFRSs

(b) Statement of the **measurement basis** (bases) and accounting policies applied

(c) **Supporting information** for items presented in each financial statement in the same order as each line item and each financial statement is presented

(d) Other disclosures, eg:

    (i) Contingent liabilities, commitments and other financial disclosures
    (ii) Non-financial disclosures

The order of specific items may have to be varied occasionally, but a systematic structure is still required.

8.3 Presentation of accounting policies

The accounting policies section should describe the following.

(a) The **measurement basis** (or bases) used in preparing the financial statements
(b) The **other accounting policies** used, as required for a proper understanding of the financial statements

This information may be shown in the notes or sometimes as a **separate component** of the financial statements.

The information on measurement bases used is obviously fundamental to an understanding of the financial statements. Where **more than one basis is used**, it should be stated to which assets or liabilities each basis has been applied.

Note: accounting policies are covered in Chapter 17.

8.4 Other disclosures

An entity must disclose in the notes:

(a) The amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to owners during the period, and the amount per share
(b) The amount of any cumulative preference dividends not recognised

IAS 1 ends by listing some **specific disclosures** which will always be required if they are not shown elsewhere in the financial statements.

(a) The domicile and legal form of the entity, its country of incorporation and the address of the registered office (or, if different, principal place of business)
(b) A description of the nature of the entity's operations and its principal activities
(c) The name of the parent entity and the ultimate parent entity of the group

The accountant of Wislon Co has prepared the following list of account balances as at 31 December 20X7.

	$'000
50c ordinary shares (fully paid)	450
10% debentures (secured)	200
Retained earnings 1.1.X7	242
General reserve 1.1.X7	171
Land and buildings 1.1.X7 (cost)	430
Plant and machinery 1.1.X7 (cost)	830
Accumulated depreciation	
Buildings 1.1.X7	20
Plant and machinery 1.1.X7	222
Inventory 1.1.X7	190
Sales	2,695
Purchases	2,152
Ordinary dividend	15
Debenture interest	10
Wages and salaries	254
Light and heat	31
Sundry expenses	113
Suspense account	135
Trade accounts receivable	179
Trade accounts payable	195
Cash	126

Notes

(a) Sundry expenses include $9,000 paid in respect of insurance for the year ending 1 September 20X8. Light and heat does not include an invoice of $3,000 for electricity for the three months ending 2 January 20X8, which was paid in February 20X8. Light and heat also includes $20,000 relating to salesmen's commission.

(b) The suspense account is in respect of the following items.

	$'000
Proceeds from the issue of 100,000 ordinary shares	120
Proceeds from the sale of plant	300
	420
Less consideration for the acquisition of Mary & Co	285
	135

(c) The net assets of Mary & Co were purchased on 3 March 20X7. Assets were valued as follows

	$'000
Equity investments	231
Inventory	34
	265

All the inventory acquired was sold during 20X7. The equity investments were still held by Wislon at 31.12.X7. Goodwill has not been impaired in value.

(d) The property was acquired some years ago. The buildings element of the cost was estimated at $100,000 and the estimated useful life of the assets was fifty years at the time of purchase. As at 31 December 20X7 the property is to be revalued at $800,000.

(e) The plant which was sold had cost $350,000 and had a carrying amount of $274,000 as on 1.1.X7. $36,000 depreciation is to be charged on plant and machinery for 20X7.

(f) The management wish to provide for:

(i) Debenture interest due

(ii) A transfer to general reserve of $16,000

(iii) Audit fees of $4,000

(g) Inventory as at 31 December 20X7 was valued at $220,000 (cost).

(h) Taxation is to be ignored.

Required

Prepare the financial statements of Wislon Co as at 31 December 20X7. You do not need to produce notes to the statements.

Answer

(a) Normal adjustments are needed for accruals and prepayments (insurance, light and heat, debenture interest and audit fees). The debenture interest accrued is calculated as follows.

	$'000
Charge needed in profit or loss (10% × $200,000)	20
Amount paid so far, as shown in list of account balances	10
Accrual: presumably six months' interest now payable	10

The accrued expenses shown in the statement of financial position comprise:

	$'000
Debenture interest	10
Light and heat	3
Audit fee	4
	17

(b) The misposting of $20,000 to light and heat is also adjusted, by reducing the light and heat expense, but charging $20,000 to salesmen's commission.

(c) Depreciation on the building is calculated as $\frac{\$100{,}000}{50}$ = $2,000.

The carrying amount of the building is then $430,000 – $20,000 – $2,000 = $408,000 at the end of the year. When the property is revalued a reserve of $800,000 – $408,000 = $392,000 is then created.

(d) The profit on disposal of plant is calculated as proceeds $300,000 (per suspense account) less carrying amount $274,000, ie $26,000. The cost of the remaining plant is calculated at $830,000 – $350,000 = $480,000. The depreciation provision at the year end is:

	$'000
Balance 1.1.X7	222
Charge for 20X7	36
Less depreciation on disposals (350 – 274)	(76)
	182

(e) Goodwill arising on the purchase of Mary & Co is:

	$'000
Consideration (per suspense account)	285
Assets at valuation	265
Goodwill	20

This is shown as an asset in the statement of financial position. The equity investments, being owned by Wislon at the year end, are also shown on the statement of financial position, whereas Mary's inventory, acquired and then sold, is added to the purchases figure for the year.

(f) The other item in the suspense account is dealt with as follows.

	$'000
Proceeds of issue of 100,000 ordinary shares	120
Less nominal value 100,000 × 50c	50
Excess of consideration over par value (= share premium)	70

(g) The transfer to general reserve increases it to $171,000 + $16,000 = $187,000.

We can now prepare the financial statements.

WISLON CO
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	$'000
Revenue	2,695
Cost of sales (W1)	(2,156)
Gross profit	539
Other income (profit on disposal of plant)	26
Administrative expenses (W2)	(437)
Finance costs	(20)
Profit for the year	108
Other comprehensive income:	
Gain on property revaluation	392
Total comprehensive income for the year	500

Note
The only item of 'other comprehensive income' for the year was the revaluation gain. If there had been no revaluation gain, only a statement of profit or loss would have been required.

Workings

1 *Cost of sales*

	$'000
Opening inventory	190
Purchases (2,152 + 34)	2,186
Closing inventory	(220)
	2,156

2 *Administrative expenses*

	$'000
Wages, salaries and commission (254 + 20)	274
Sundry expenses (113 – 6)	107
Light and heat (31 – 20 + 3)	14
Depreciation: buildings	2
plant	36
Audit fees	4
	437

WISLON CO

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X7

		$'000	$'000
Assets			
Non-current assets			
Property, plant and equipment			
Property at valuation			800
Plant:	cost	480	
	Accumulated depreciation	(182)	
			298
Goodwill			20
Equity investments			231
Current assets			
Inventory		220	
Trade accounts receivable		179	
Prepayments		6	
Cash		126	
			531
Total assets			1,880
Equity and liabilities			
Equity			
50c ordinary shares		500	
Share premium		70	
Revaluation surplus		392	
General reserve		187	
Retained earnings		319	
			1,468
Non-current liabilities			
10% loan stock (secured)			200
Current liabilities			
Trade accounts payable		195	
Accrued expenses		17	
			212
Total equity and liabilities			1,880

WISLON CO

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	*Share premium*	*Retained earnings*	*General reserve*	*Revaluation Surplus*	*Total*
	$'000	$'000	$'000	$'000	$'000	$'000
Balance at 1.1.X7	450	–	242	171	-	863
Issue of share capital	50	70				120
Dividends			(15)			(15)
Total comprehensive income for the year			108		392	500
Transfer to reserve			(16)	16		
Balance at 31.12.X7	500	70	319	187	392	1,468

Note that the total comprehensive income is analysed into its components.

9 IAS 34 Interim financial reporting

FAST FORWARD

IAS 34 recommends that **entities should produce interim financial reports,** and for entities that do publish such reports, it lays down principles and guidelines for their production.

The following definitions are used in IAS 34.

Key terms

- **Interim period** is a financial reporting period shorter than a full financial year.
- **Interim financial report** means a financial report containing either a complete set of financial statements (as described in IAS 1) or a set of condensed financial statements (as described in this standard) for an interim period. *(IAS 34)*

9.1 Scope

The standard does not make the preparation of interim financial reports **mandatory**, taking the view that this is a matter for governments, securities regulators, stock exchanges or professional accountancy bodies to decide within each country. The IASB does, however, strongly recommend to governments, etc, that interim financial reporting should be a requirement for companies whose equity or debt securities are **publicly traded**.

(a) An interim financial report should be produced by such companies for **at least the first six months of their financial year** (ie a half year financial report).

(b) The report should be **available no later than 60 days** after the end of the interim period.

Therefore, a company with a year ending 31 December would be required as a minimum to prepare an interim report for the half year to 30 June and this report should be available before the end of August.

9.2 Minimum components

The proposed standard specifies the **minimum component elements** of an interim financial report.

- Condensed statement of financial position
- Condensed statement of profit or loss and other comprehensive income
- Condensed statement of changes in equity
- Condensed statement of cash flows
- Selected note disclosures

The rationale for requiring only condensed statements and selected note disclosures is that entities need not duplicate information in their interim report that is contained in their report for the previous financial year. Interim statements should **focus more on new events, activities and circumstances**.

9.3 Form and content

Where **full financial statements** are given as interim financial statements, IAS 1 should be used as a guide, otherwise IAS 34 specifies minimum contents.

The **condensed statement of financial position** should include, as a minimum, each of the major components of assets, liabilities and equity as were in the statement of financial position at the end of the previous financial year, thus providing a summary of the economic resources of the entity and its financial structure.

The **condensed statement of profit or loss and other comprehensive income** should include, as a minimum, each of the component items of income and expense as are shown in profit or loss for the previous financial year, together with the earnings per share and diluted earnings per share.

The **condensed statement of cash flows** should show, as a minimum, the three major sub-totals of cash flow as required in statements of cash flows by IAS 7, namely: cash flows from operating activities, cash flows from investing activities and cash flow from financing activities.

The **condensed statement of changes in equity** should include, as a minimum, each of the major components of equity as were contained in the statement of changes in equity for the previous financial year of the entity.

9.3.1 Selected explanatory notes

IAS 34 states that **relatively minor changes** from the most recent annual financial statements need not be included in an interim report. However, the notes to interim report should include the following (unless the information is contained elsewhere in the report).

(a) A statement that the **same accounting policies and methods of computation** have been used for the interim statements as were used for the most recent annual financial statements. If not, the nature of the differences and their effect should be described. (The accounting policies for preparing the interim report should only differ from those used for the previous annual accounts in a situation where there has been a change in accounting policy since the end of the previous financial year, and the new policy will be applied for the annual accounts of the current financial period.)

(b) Explanatory comments on the **seasonality or 'cyclicality'** of operations in the interim period. For example, if a company earns most of its annual profits in the first half of the year, because sales are much higher in the first six months, the interim report for the first half of the year should explain this fact

(c) The **nature and amount** of items during the interim period affecting assets, liabilities, capital, net income or cash flows, that are unusual, due to their nature, incidence or size

(d) The **issue or repurchase** of equity or debt securities

(e) Nature and amount of any **changes in estimates** of amounts reported in an earlier interim report during the financial year, or in prior financial years if these affect the current interim period

(f) **Dividends paid** on ordinary shares and the dividends paid on other shares

(g) **Segmental results** for the business segments or geographical segments of the entity (see IFRS 8)

(h) Any **significant events since the end of the interim period**

(i) Effect of the acquisition or disposal of subsidiaries during the interim period

(j) Any significant change in a **contingent liability or a contingent asset** since the date of the last annual statement of financial position

The entity should also disclose the fact that the interim report has been produced **in compliance with** IAS 34 on interim financial reporting.

Question

Disclosures

Give some examples of the type of disclosures required according to the above list of explanatory notes.

Answer

The following are examples.

(a) Write-down of inventories to net realisable value and the reversal of such a write-down

(b) Recognition of a loss from the impairment of property, plant and equipment, intangible assets, or other assets, and the reversal of such an impairment loss

(c) Reversal of any provisions for the costs of restructuring

(d) Acquisitions and disposals of items of property, plant and equipment

(e) Commitments for the purchase of property, plant and equipment

(f) Litigation settlements

(g) Corrections of fundamental errors in previously reported financial data

(h) Any debt default or any breach of a debt covenant that has not been corrected subsequently

(i) Related party transactions

9.4 Periods covered

The standard requires that interim financial reports should provide financial information for the following periods or as at the following dates.

(a) **Statement of financial position data** as at the end of the current interim period, and comparative data as at the end of the most recent financial year

(b) **Statement of profit or loss and other comprehensive income data** for the current interim period and cumulative data for the current year to date, together with comparative data for the corresponding interim period and cumulative figures for the previous financial year

(c) **Statement of cash flows data** should be *cumulative* for the current year to date, with comparative cumulative data for the corresponding interim period in the previous financial year

(d) **Data for the statement of changes in equity** should be for both the current interim period and for the year to date, together with comparative data for the corresponding interim period, and cumulative figures, for the previous financial year

9.5 Materiality

Materiality should be assessed in relation to the interim period financial data. It should be recognised that interim measurements **rely to a greater extent on estimates** than annual financial data.

9.6 Recognition and measurement principles

A large part of IAS 34 deals with recognition and measurement principles, and guidelines as to their practical application. The **guiding principle** is that an entity should use the **same recognition and measurement principles in its interim statements as it does in its annual financial statements**.

This means, for example, that a cost that would not be regarded as an asset in the year-end statement of financial position should not be regarded as an asset in the statement of financial position for an interim period. Similarly, an accrual for an item of income or expense for a transaction that has not yet occurred (or a deferral of an item of income or expense for a transaction that has already occurred) is inappropriate for interim reporting, just as it is for year-end reporting.

Applying this principle of recognition and measurement may result, in a subsequent interim period or at the year-end, in a **remeasurement** of amounts that were reported in a financial statement for a previous interim period. **The nature and amount of any significant remeasurements should be disclosed**.

9.6.1 Revenues received occasionally, seasonally or cyclically

Revenue that is received as an occasional item, or within a seasonal or cyclical pattern, should not be anticipated or deferred in interim financial statements, if it would be inappropriate to anticipate or defer the revenue for the annual financial statements. In other words, the principles of revenue recognition should be applied consistently to the interim reports and year-end reports.

9.6.2 Costs incurred unevenly during the financial year

These should only be anticipated or deferred (ie treated as accruals or prepayments) if it would be appropriate to anticipate or defer the expense in the annual financial statements. For example, it would be appropriate to anticipate a cost for property rental where the rental is paid in arrears, but it would be inappropriate to anticipate part of the cost of a major advertising campaign later in the year, for which no expenses have yet been incurred.

The standard goes on, in an appendix, to deal with **specific applications** of the recognition and measurement principle. Some of these examples are explained below, by way of explanation and illustration.

9.6.3 Payroll taxes or insurance contributions paid by employers

In some countries these are assessed on an annual basis, but paid at an uneven rate during the course of the year, with a large proportion of the taxes being paid in the early part of the year, and a much smaller proportion paid later on in the year. In this situation, it would be appropriate to use an estimated average annual tax rate for the year in an interim statement, not the actual tax paid. This treatment is appropriate because it reflects the fact that the taxes are assessed on an annual basis, even though the payment pattern is uneven.

9.6.4 Cost of a planned major periodic maintenance or overhaul

The cost of such an event later in the year must not be anticipated in an interim financial statement *unless* there is a legal or constructive obligation to carry out this work. The fact that a maintenance or overhaul is planned and is carried out annually is not of itself sufficient to justify anticipating the cost in an interim financial report.

9.6.5 Other planned but irregularly-occurring costs

Similarly, these costs such as charitable donations or employee training costs, should not be accrued in an interim report. These costs, even if they occur regularly and are planned, are nevertheless discretionary.

9.6.6 Year-end bonus

A year-end bonus should not be provided for in an interim financial statement *unless* there is a constructive obligation to pay a year-end bonus (eg a contractual obligation, or a regular past practice) and the size of the bonus can be reliably measured.

9.6.7 Holiday pay

The same principle applies here. If holiday pay is an enforceable obligation on the employer, then any unpaid accumulated holiday pay may be accrued in the interim financial report.

9.6.8 Non-mandatory intangible assets

The entity might incur expenses during an interim period on items that might or will generate non-monetary intangible assets. IAS 38 *Intangible assets* requires that costs to generate non-monetary intangible assets (eg development expenses) should be recognised as an expense when incurred *unless* the costs form part of an identifiable intangible asset. Costs that were initially recognised as an expense cannot subsequently be treated instead as part of the cost of an intangible asset. IAS 34 states that interim financial statements should adopt the same approach. This means that it would be inappropriate in an interim financial statement to 'defer' a cost in the expectation that it will eventually be part of a non-monetary intangible asset that has not yet been recognised: such costs should be treated as an expense in the interim statement.

9.6.9 Depreciation

Depreciation should only be charged in an interim statement on non-current assets that have been acquired, not on non-current assets that will be acquired later in the financial year.

9.7 Foreign currency translation gains and losses

These should be calculated by the same principles as at the financial year end, in accordance with IAS 21.

9.7.1 Tax on income

An entity will include an expense for income tax (tax on profits) in its interim statements. The **tax rate** to use should be the estimated average annual tax rate for the year. For example, suppose that in a particular jurisdiction, the rate of tax on company profits is 30% on the first $200,000 of profit and 40% on profits

above $200,000. Now suppose that a company makes a profit of $200,000 in its first half year, and expects to make $200,000 in the second half year. The rate of tax to be applied in the interim financial report should be 35%, not 30%, ie the expected average rate of tax for the year as a whole. This approach is appropriate because income tax on company profits is charged on an annual basis, and an effective annual rate should therefore be applied to each interim period.

As another illustration, suppose a company earns pre-tax income in the first quarter of the year of $30,000, but expects to make a loss of $10,000 in each of the next three quarters, so that net income before tax for the year is zero. Suppose also that the rate of tax is 30%. In this case, it would be inappropriate to anticipate the losses, and the tax charge should be $9,000 for the first quarter of the year (30% of $30,000) and a negative tax charge of $3,000 for each of the next three quarters, if actual losses are the same as anticipated.

Where the tax year for a company does not coincide with its financial year, a separate estimated weighted average tax rate should be applied for each tax year, to the interim periods that fall within that tax year.

Some countries give entities tax credits against the tax payable, based on amounts of capital expenditure or research and development, and so on. Under most tax regimes, these credits are calculated and granted on an annual basis; therefore it is appropriate to include anticipated tax credits within the calculation of the estimated average tax rate for the year, and apply this rate to calculate the tax on income for interim periods. However, if a tax benefit relates to a specific one-time event, it should be recognised within the tax expense for the interim period in which the event occurs.

9.7.2 Inventory valuations

Within interim reports, inventories should be valued in the same way as for year-end accounts. It is recognised, however, that it will be necessary to rely more heavily on estimates for interim reporting than for year-end reporting.

In addition, it will normally be the case that the net realisable value of inventories should be estimated from selling prices and related costs to complete and dispose at interim dates.

9.8 Use of estimates

Although accounting information must be reliable and free from material error, it may be necessary to sacrifice some accuracy and reliability for the sake of timeliness and cost-benefits. This is particularly the case with interim financial reporting, where there will be much less time to produce reports than at the financial year end. The proposed standard therefore recognises that estimates will have to be used to a greater extent in interim reporting, to assess values or even some costs, than in year-end reporting.

An appendix to IAS 34 gives some examples of the use of estimates.

(a) **Inventories**. An entity might not need to carry out a full inventory count at the end of each interim period. Instead, it may be sufficient to estimate inventory values using sales margins.

(b) **Provisions**. An entity might employ outside experts or consultants to advise on the appropriate amount of a provision, as at the year end. It will probably be inappropriate to employ an expert to make a similar assessment at each interim date. Similarly, an entity might employ a professional valuer to revalue non-current assets at the year end, whereas at the interim date(s) the entity will not rely on such experts.

(c) **Income taxes**. The rate of income tax (tax on profits) will be calculated at the year end by applying the tax rate in each country/jurisdiction to the profits earned there. At the interim stage, it may be sufficient to estimate the rate of income tax by applying the same 'blended' estimated weighted average tax rate to the income earned in all countries/jurisdictions.

The principle of **materiality** applies to interim financial reporting, as it does to year-end reporting.
In assessing materiality, it needs to be recognised that interim financial reports will rely more heavily on estimates than year-end reports. Materiality should be assessed in relation to the interim financial statements themselves, and should be independent of 'annual materiality' considerations.

9.9 Section summary

- IAS 34 in concept makes **straightforward proposals** for the production of interim financial reports by entities
- It is essential to apply **principles of recognition and measurement** that will prevent entities from 'massaging' the interim figures
- The **detail** in the guidelines is therefore very important, and the application of the recognition and measurement principles to particular valuations and measurements needs to be understood

10 Fair presentation and compliance with IFRS

Most importantly, financial statements should **present fairly** the financial position, financial performance and cash flows of an entity. **Compliance with IFRS** is presumed to result in financial statements that achieve a fair presentation.

The following points made by IAS 1 expand on this principle.

(a) **Compliance with IFRS** should be disclosed

(b) **All relevant IFRS** must be followed if compliance with IFRS is disclosed

(c) Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material

There may be (very rare) circumstances when management decides that compliance with a requirement of an IFRS would be misleading. **Departure from the IFRS** is therefore required to achieve a fair presentation. The following should be disclosed in such an event.

(a) Management confirmation that the financial statements fairly present the entity's financial position, performance and cash flows

(b) Statement that all IFRS have been complied with *except* departure from one IFRS to achieve a fair presentation

(c) Details of the nature of the departure, why the IFRS treatment would be misleading, and the treatment adopted

(d) Financial impact of the departure

This is usually referred to as the 'true and fair override'.

10.1 Extreme case disclosures

In very rare circumstances, management may conclude that compliance with a requirement in a Standard or interpretation may be so **misleading** that it would **conflict with the objective** of financial statements set out in the *Conceptual Framework*, but the relevant regulatory framework prohibits departure from the requirements. In such cases the entity needs to reduce the perceived misleading aspects of compliance by **disclosing**:

(a) The title of the Standard, the nature of the requirement and the reason why management has reached its conclusion.

(b) For each period, the adjustment to each item in the financial statements that would be necessary to achieve fair presentation.

IAS 1 states what is required for a fair presentation.

(a) Selection and application of **accounting policies**

(b) **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information

(c) **Additional disclosures** where required

Chapter Roundup

- IAS 1 covers the **form and content of** financial statements. The main components are:
  - Statement of financial position
  - Statement of profit or loss and other comprehensive income
  - Statement of changes in equity
  - Statement of cash flows
  - Notes to the financial statements
- IAS 1 suggests a format for the statement of financial position. Certain items are specified for **disclosure on the face of the financial statements**.
- You should appreciate the distinction between current and non-current assets and liabilities and their different treatments.
- In June 2011 the IASB published an amendment to IAS 1 called 'Presentation of items of other comprehensive income'. This changed the name of the statement of comprehensive income to 'statement of profit or loss and other comprehensive income'.
- IAS 1 offers **two** possible formats for the statement of profit or loss or separate profit or loss section – by **function or by nature**. Classification by function is more common.
- IAS 1 requires a statement of changes in equity. This shows the movement in the equity section of the statement of financial position. A full set of financial statements includes a statement of changes in equity.
- Some items need to be disclosed by way of a note.
- IAS 34 recommends that **entities should produce interim financial reports,** and for entities that do publish such reports, it lays down principles and guidelines for their production.

Quick Quiz

1 Which of the following are examples of current assets?
   (a) Property, plant and equipment
   (b) Prepayments
   (c) Cash equivalents
   (d) Manufacturing licences
   (e) Retained earnings

2 Provisions must be disclosed in the statement of financial position. True/False?

3 Which of the following must be disclosed on the face of the statement of profit or loss?
   (a) Tax expense
   (b) Analysis of expenses
   (c) Net profit or loss for the period.

4 Where are revaluation gains shown in the financial statements?

Answers to Quick Quiz

1 (b) and (c) only
2 True
3 (a) and (c) only. (b) may be shown in the notes.
4 In other comprehensive income and in the statement of changes in equity.

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q20	Intermediate	40	72 mins
Q21	Examination	40	72 mins

17

Reporting financial performance

Topic list	Syllabus reference
1 IAS 8 Accounting policies, changes in accounting estimates and errors	C4
2 Changes in accounting polices	C4
3 Errors	C4
4 IFRS 5 Non-current assets held for sale and discontinued operations	C1. B2
5 IAS 10 Events after the reporting period	C3

Introduction

IAS 8 deals with accounting policies. It also looks at certain circumstances and transactions which require different treatment to normal profit or loss items.

IFRS 5 on assets held for sale and discontinued operations is an important standard which gives users additional information regarding the sources of the entity's profit and losses.

IAS 10 sets out the treatment for events occurring after the accounting year end.

Study guide

C1	**Presentation of the statement of financial position, and statement of profit or loss and other comprehensive income**
(a)	Discuss the importance of identifying and reporting the results of discontinued operations
(b)	Define and account for non-current assets held for sale and discontinued operations
C3	**Events after the reporting date**
(a)	Distinguish between and account for adjusting and non-adjusting events after the reporting period
C4	**Accounting policies, changes in accounting estimates and errors**
(a)	Identify items requiring separate disclosure, including their accounting treatment and required disclosures
(b)	Recognise the circumstances where a change in accounting policy is justified
(c)	Define prior period adjustments and 'errors' and account for the correction of errors and changes in accounting policies
B2	**Property, plant and equipment**
(h)	Describe the criteria that need to be present before non-current assets are classified as held for sale, either individually or in a disposal group
(i)	Account for non-current assets and disposal groups that are held for sale

1 IAS 8 Accounting policies, changes in accounting estimates and errors

FAST FORWARD

IAS 8 deals with changes in accounting estimates, changes in accounting policies and errors.

1.1 Definitions

The following definitions are given in the standard.

Key terms

- **Accounting policies** are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.
- A **change in accounting estimate** is an adjustment of the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.
- **Material**. Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.
- **Prior period errors** are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:
  - Was available when financial statements for those periods were authorised for issue, and
  - Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

  Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Key terms (cont'd)

- **Retrospective application** is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.
- **Retrospective restatement** is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.
- **Prospective application** of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:
  – Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
  – Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.
- **Impracticable.** Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. It is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if one of the following apply.
  – The effects of the retrospective application or retrospective restatement are not determinable.
  – The retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period.
  – The retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that: provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognised, measured or disclosed; and would have been available when the financial statements for that prior period were authorised for issue, from other information.

(IAS 8)

1.2 Accounting policies

Accounting policies are determined by **applying the relevant IAS, IFRS or IFRS Interpretation** and considering any relevant Implementation Guidance issued by the IASB for that IFRS/Interpretation.

Where there is no applicable IFRS or Interpretation management should use its **judgement** in developing and applying an accounting policy that results in information that is **relevant** and **reliable**. Management should refer to:

(a) The requirements and guidance in IFRSs and IFRICs dealing with **similar** and **related issues**

(b) The definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the **Conceptual Framework**

Management may also consider the most recent pronouncements of **other standard setting bodies** that use a similar conceptual framework to develop standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

An entity must select and apply its accounting policies for a period **consistently** for similar transactions, other events and conditions, unless an IFRS or an IFRIC specifically requires or permits categorisation of items for which different policies may be appropriate. If an IFRS or an IFRIC requires or permits categorisation of items, an appropriate accounting policy must be selected and applied consistently to each category.

2 Changes in accounting policies

FAST FORWARD

Changes in accounting policy are applied **retrospectively**.

2.1 Accounting for changes of policy

The same accounting policies are usually adopted from period to period, to allow users to analyse trends over time in profit, cash flows and financial position. **Changes in accounting policy will therefore be rare** and should be made only if :

(a) The change is required by an IFRS; or

(b) The change will result in a **more appropriate presentation** of events or transactions in the financial statements of the entity, providing more reliable and relevant information.

The standard highlights two types of event which do not constitute changes in accounting policy.

(a) Adopting an accounting policy for a **new type of transaction** or event not dealt with previously by the entity.

(b) Adopting a **new accounting policy** for a transaction or event which has not occurred in the past or which was not material.

In the case of tangible non-current assets, if a policy of revaluation is adopted for the first time then this is treated, not as a change of accounting policy under IAS 8, but as a revaluation under IAS 16 Property, plant and equipment (see Chapter 4). The following paragraphs do not therefore apply to a change in policy to adopt revaluations.

A change in accounting policy **must be applied retrospectively**. **Retrospective application** means that the new accounting policy is applied to transactions and events as if it had always been in use. In other words, at the earliest date such transactions or events occurred, the policy is applied from that date.

Prospective application is **no longer allowed** under the revised IAS 8 unless it is **impracticable** (see Key Terms) to determine the cumulative effect of the change.

2.2 Worked example: change of accounting policy

A company has always valued inventory on a FIFO (first in, first out) basis. In 20X9 it decides to switch to the weighted average method of valuation. Gross profit in the 20X8 financial statements was calculated as follows:

		$'000
Revenue		869
Cost of sales:		
Opening inventory	135	
Purchases	246	
Closing inventory	(174)	(207)
Gross profit		662

In order to prepare comparative figures for 20X8 showing the change of accounting policy, it is necessary to recalculate the amounts for 20X7, so that the opening inventory for 20X8 is valued on a weighted average basis.

It is established that opening inventory for 20X8 based on the weighted average method would be $122,000 and closing inventory would be $143,000. So the 20X8 gross profit now becomes:

		$'000
Revenue		869
Cost of sales:		
Opening inventory	122	
Purchases	246	
Closing inventory	(143)	(225)
		644

This shows $18,000 lower gross profit for 20X8 which will reduce net profit and retained earnings by the same amount. The opening inventory for 20X9 will be $143,000 rather than $174,000 and the statement of changes in equity for 20X9 will show an $18,000 adjustment to opening retained earnings.

2.3 Adoption of an IFRS

Where a new IFRS is adopted, resulting in a change of accounting policy, IAS 8 requires any transitional provisions in the new IFRS itself to be followed. If none are given in the IFRS which is being adopted, then you should follow the general principles of IAS 8.

2.4 Disclosure

Certain **disclosures** are required when a change in accounting policy has a material effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods.

(a) Reasons for the change / nature of change
(b) Amount of the adjustment for the current period and for each period presented
(c) Amount of the adjustment relating to periods prior to those included in the comparative information
(d) The fact that comparative information has been restated or that it is impracticable to do so

An entity should also disclose information relevant to assessing the **impact of new IFRS** on the financial statements where these have **not yet come into force.**

2.5 Changes in accounting estimates

FAST FORWARD

Changes in accounting estimate are **not** applied retrospectively.

Estimates arise in relation to business activities because of the **uncertainties inherent within them**. Judgements are made based on the most up to date information and the use of such estimates is a necessary part of the preparation of financial statements. It does not undermine their reliability. Here are some examples of accounting estimates.

(a) A necessary **irrecoverable debt allowance**
(b) **Useful lives** of depreciable assets
(c) Provision for **obsolescence of inventory**

The rule here is that the **effect of a change in an accounting estimate** should be included in the determination of net profit or loss in one of:

(a) The period of the change, if the change affects that period only
(b) The period of the change and future periods, if the change affects both

Changes may occur in the circumstances which were in force at the time the estimate was calculated, or perhaps additional information or subsequent developments have come to light.

An example of a change in accounting estimate which affects only the **current period** is the bad debt estimate. However, a revision in the life over which an asset is depreciated would affect both the **current and future periods**, in the amount of the depreciation expense.

Reasonably enough, the effect of a change in an accounting estimate should be included in the **same expense classification** as was used previously for the estimate. This rule helps to ensure **consistency** between the financial statements of different periods.

The **materiality** of the change is also relevant. The nature and amount of a change in an accounting estimate that has a material effect in the current period (or which is expected to have a material effect in subsequent periods) should be disclosed. If it is not possible to quantify the amount, this impracticability should be disclosed.

3 Errors

FAST FORWARD

Prior period errors must be corrected **retrospectively**.

3.1 Introduction

Errors discovered during a current period which **relate to a prior period** may arise through:

(a) Mathematical mistakes
(b) Mistakes in the application of accounting policies
(c) Misinterpretation of facts
(d) Oversights
(e) Fraud

A more formal definition is given in the Key Terms in Paragraph 1.1.

Most of the time these errors can be **corrected through net profit or loss for the current period**. Where they are material prior period errors, however, this is not appropriate. The standard considers two possible treatments.

3.2 Accounting treatment

Prior period errors: correct retrospectively. There is no longer any allowed alternative treatment. This involves:

(a) Either restating the comparative amounts for the prior period(s) in which the error occurred,

(b) Or, when the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for that period

so that the financial statements are presented **as if the error had never occurred**.

Only where it is **impracticable** to determine the cumulative effect of an error on prior periods can an entity correct an error **prospectively**.

Various **disclosures** are required.

(a) **Nature** of the prior period error

(b) For each prior period, to the extent practicable, the **amount** of the correction.

    (i) For each financial statement line item affected
    (ii) If IAS 33 applies, for basic and diluted earnings per share

(c) The amount of the correction at the **beginning of the earliest prior period** presented

(d) If **retrospective restatement is impracticable** for a particular prior period, the **circumstances** that led to the existence of that condition and a description of how and from when the error has been corrected. Subsequent periods need not repeat these disclosures.

Exam focus point

If you have to deal with a change of accounting policy or an error in an accounts preparation question, remember to adjust the balance of retained earnings brought forward.

Question

Error

During 20X7 Global discovered that certain items had been included in inventory at 31 December 20X6, valued at $4.2m, which had in fact been sold before the year end. The following figures for 20X6 (as reported) and 20X7 (draft) are available.

	20X6	20X7 (draft)
	$'000	$'000
Sales	47,400	67,200
Cost of goods sold	(34,570)	(55,800)
Profit before taxation	12,830	11,400
Income taxes	(3,880)	(3,400)
Profit for the period	8,950	8,000

Retained earnings at 1 January 20X6 were $13m. The cost of goods sold for 20X7 includes the $4.2m error in opening inventory. The income tax rate was 30% for 20X6 and 20X7. No dividends have been declared or paid.

Required

Show the statement of profit or loss for 20X7, with the 20X6 comparative, and retained earnings.

Answer

STATEMENT OF PROFIT OR LOSS

	20X6	20X7
	$'000	$'000
Sales	47,400	67,200
Cost of goods sold (W1)	(38,770)	(51,600)
Profit before tax	8,630	15,600
Income tax (W2)	(2,620)	(4,660)
Profit for the year	6,010	10,940

RETAINED EARNINGS

	20X6	20X7
Opening retained earnings	$'000	$'000
As previously reported (13,000 + 8,950)	13,000	21,950
Correction of prior period error (4,200 – 1,260)	–	(2,940)
As restated	13,000	19,010
Profit for the year	6,010	10,940
Closing retained earnings	19,010	29,950

Workings

1 Cost of goods sold

	20X6	20X7
	$'000	$'000
As stated in question	34,570	55,800
Inventory adjustment	4,200	(4,200)
	38,770	51,600

2 Income tax

	20X6	20X7
	$'000	$'000
As stated in question	3,880	3,400
Inventory adjustment (4,200 × 30%)	(1,260)	1,260
	2,620	4,660

4 IFRS 5 Non-current assets held for sale and discontinued operations

FAST FORWARD

IFRS 5 requires assets 'held for sale' to be presented separately in the statement of financial position. It sets out the criteria for recognising a **discontinued operation**.

IFRS 5 is examined quite frequently. It often crops up as a discursive part of a question.

4.1 Background

IFRS 5 is the result of a short-term convergence project with the US Financial Accounting Standards Board (FASB).

IFRS 5 requires assets and groups of assets that are 'held for sale' to be **presented separately** in the statement of financial position and the results of discontinued operations to be presented separately in the statement of profit or loss and other comprehensive income. This is required so that users of financial statements will be better able to make **projections** about the financial position, profits and cash flows of the entity.

Key terms

Disposal group. A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. (In practice a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

Cash-generating unit. The smallest identifiable group of assets for which independent cash flows can be identified and measured *(IFRS 5)*

IFRS 5 does not apply to certain assets covered by other accounting standards:

(a) Deferred tax assets (IAS 12)
(b) Assets arising from employee benefits (IAS 19)
(c) Financial assets (IFRS 9)
(d) Investment properties accounted for in accordance with the fair value model (IAS 40)
(e) Agricultural and biological assets (IAS 41)
(f) Insurance contracts (IFRS 4)

4.2 Classification of assets held for sale

A non-current asset (or disposal group) should be classified as **held for sale** if its carrying amount will be recovered **principally through a sale transaction** rather than **through continuing use**. A number of detailed criteria must be met:

(a) The asset must be **available for immediate sale** in its present condition.
(b) Its sale must be **highly probable** (ie significantly more likely than not).

For the sale to be highly probable, the following must apply.

(a) Management must be **committed** to a plan to sell the asset.
(b) There must be an active programme to **locate a buyer.**
(c) The asset must be marketed for sale at a **price that is reasonable** in relation to its current fair value.
(d) The sale should be expected to take place **within one year** from the date of classification.
(e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

An asset (or disposal group) can still be classified as held for sale, even if the sale has not actually taken place within one year. However, the delay must have been **caused by events or circumstances beyond the entity's control** and there must be sufficient evidence that the entity is still committed to sell the asset or disposal group. Otherwise the entity must cease to classify the asset as held for sale.

If an entity acquires a disposal group (eg, a subsidiary) exclusively with a view to its subsequent disposal it can classify the asset as held for sale only if the sale is expected to take place within one year and it is highly probable that all the other criteria will be met within a short time (normally three months).

An asset that is to be **abandoned** should not be classified as held for sale. This is because its carrying amount will be recovered principally through continuing use. However, a disposal group to be abandoned may meet the definition of a discontinued operation and therefore separate disclosure may be required (see below).

Question — Held for sale

On 1 December 20X3, a company became committed to a plan to sell a manufacturing facility and has already found a potential buyer. The company does not intend to discontinue the operations currently carried out in the facility. At 31 December 20X3 there is a backlog of uncompleted customer orders. The company will not be able to transfer the facility to the buyer until after it ceases to operate the facility and has eliminated the backlog of uncompleted customer orders. This is not expected to occur until spring 20X4.

Required

Can the manufacturing facility be classified as 'held for sale' at 31 December 20X3?

Answer

The facility will not be transferred until the backlog of orders is completed; this demonstrates that the facility is not available for immediate sale in its present condition. The facility cannot be classified as 'held for sale' at 31 December 20X3. It must be treated in the same way as other items of property, plant and equipment: it should continue to be depreciated and should not be separately disclosed.

4.3 Measurement of assets held for sale

Key terms

Fair value: the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Costs of disposal: the incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.

Recoverable amount: the higher of an asset's fair value less costs of disposal and its value in use.

Value in use: the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

A non-current asset (or disposal group) that is held for sale should be measured at the **lower of** its **carrying amount** and **fair value less costs of disposal**. Fair value less costs of disposal is equivalent to net realisable value.

An impairment loss should be recognised where fair value less costs of disposal is lower than carrying amount. Note that this is an exception to the normal rule. IAS 36 *Impairment of assets* requires an entity to recognise an impairment loss only where an asset's recoverable amount is lower than its carrying value. Recoverable amount is defined as the higher of fair value less costs of disposal and value in use. IAS 36 does not apply to assets held for sale. An impairment loss on an asset held under IFRS 5 is charged to **profit or loss**.

Non-current assets held for sale **should not be depreciated**, even if they are still being used by the entity. However, any impairment (arising for instance from an increase in costs of disposal) is recognised and charged to profit or loss.

A non-current asset (or disposal group) that is **no longer classified as held for sale** (for example, because the sale has not taken place within one year) is measured at the **lower of**:

(a) Its **carrying amount** before it was classified as held for sale, adjusted for any depreciation that would have been charged had the asset not been held for sale

(b) Its **recoverable amount** at the date of the decision not to sell

4.4 Presentation of a non-current asset or disposal group classified as held for sale

Non-current assets and disposal groups classified as held for sale should be **presented separately** from other assets in the statement of financial position. The liabilities of a disposal group should be presented separately from other liabilities in the statement of financial position.

(a) Assets and liabilities held for sale **should not be offset**.

(b) The **major classes** of assets and liabilities held for sale should be **separately disclosed** either on the face of the statement of financial position or in the notes.

(c) IFRS 5 requires non-current assets or disposal groups held for sale to be shown as a separate component of **current assets/current liabilities.**

For example (taken from standard)

ASSETS	
Non-current assets	
AAA	X
Current assets	
BBB	X
CCC	X
	X
Non-current assets classified as held for sale	X
	X
Total assets	X
EQUITY AND LIABILITIES	
Equity	
DDD	X
Non-current liabilities	
EEE	X
Current liabilities	
FFF	X
GGG	X
Liabilities directly associated with non-current assets classified as held for sale	X
	X
Total equity and liabilities	X

4.5 Additional disclosures

In the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold the following should be disclosed.

(a) A **description** of the non-current asset (or disposal group)

(b) A description of the **facts and circumstances** of the disposal

(c) Any **gain or loss** recognised when the item was classified as held for sale

Where an asset previously classified as held for sale is **no longer held for sale**, the entity should disclose a description of the facts and circumstances leading to the decision and its effect on results.

4.6 Presenting discontinued operations

Key terms

Discontinued operation: a component of an entity that has either been disposed of, or is classified as held for sale, and:

(a) Represents a separate major line of business or geographical area of operations
(b) Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or
(c) Is a subsidiary acquired exclusively with a view to resale.

Component of an entity: operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

An entity should **present and disclose information** that enables users of the financial statements to evaluate the financial effects of **discontinued operations** and disposals of non-current assets or disposal groups.

This allows users to distinguish between operations which will continue in the future and those which will not, and makes it more possible to predict future results.

An entity should disclose a **single amount** in the statement of profit or loss comprising the total of:

(a) The **post-tax profit or loss** of discontinued operations and
(b) The post-tax gain or loss recognised on the **measurement to fair value less costs of disposal** or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

An entity should also disclose an **analysis** of this single amount into:

(a) The revenue, expenses and pre-tax profit or loss of discontinued operations
(b) The related income tax expense
(c) The gain or loss recognised on the measurement to fair value less costs of disposal or on the disposal of the assets of the discontinued operation
(d) The related income tax expense

This may be presented either in the statement of profit or loss or in the notes. If it is presented in the statement of profit or loss it should be presented in a section identified as relating to discontinued operations, ie separately from continuing operations. This analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale.

An entity should disclose the **net cash flows** attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the statement of cash flows or in the notes.

Gains and losses on the remeasurement of a disposal group that is not a discontinued operation but is held for sale should be included in profit or loss from continuing operations.

Exam focus point

The December 2013 paper included seven marks in question four for explaining and showing how to report the disposal of the 'trade and assets of a business [which the entity] had acquired'.

4.7 Illustration

The following illustration is taken from the implementation guidance to IFRS 5. Profit for the period from discontinued operations would be analysed in the notes.

XYZ GROUP

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2

	20X2	20X1
Continuing operations	$'000	$'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year from continuing operations	X	X
Discontinued operations		
Profit for the year from discontinued operations	X	X
Profit for the year	X	X
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

Note that if there were items of 'other comprehensive income' this would be shown as a full 'statement of profit or loss and other comprehensive income' as per the format in Chapter 3.

Question

Closure

On 20 October 20X3 the directors of a parent company made a public announcement of plans to close a steel works. The closure means that the group will no longer carry out this type of operation, which until recently has represented about 10% of its total revenue. The works will be gradually shut down over a period of several months, with complete closure expected in July 20X4. At 31 December output had been significantly reduced and some redundancies had already taken place. The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the subsidiary's other operations.

Required

How should the closure be treated in the financial statements for the year ended 31 December 20X3?

Answer

Because the steel works is being closed, rather than sold, it cannot be classified as 'held for sale'. In addition, the steel works is not a discontinued operation. Although at 31 December 20X3 the group was firmly committed to the closure, this has not yet taken place nor can its assets be classified as held for sale, therefore the steel works must be included in continuing operations. Information about the planned closure could be disclosed in the notes to the financial statements.

5 IAS 10: Events after the reporting period

FAST FORWARD

IAS 10 sets out the criteria for recognising **events occurring after the reporting date**.

The standard gives the following definition.

Key term

Events occurring after the reporting period are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date on which the financial statements are authorised for issue. Two types of events can be identified.

- Those that provide evidence of conditions that existed at the end of the reporting period – *adjusting*
- Those that are indicative of conditions that arose after the reporting period – *non-adjusting*

(IAS 10)

The financial statements are significant indicators of a company's success or failure. It is important, therefore, that they include all the information necessary for an understanding of the company's position.

Between the end of the reporting period and the date the financial statements are authorised (ie for issue outside the organisation), **events may occur** which show that assets and liabilities at the end of the reporting period should be adjusted, or that disclosure of such events should be given.

Exam focus point

The financial statements preparation question in the pilot paper included a part dealing with events after the reporting period.

A past exam question asked candidates to:

- Explain why events after the reporting period might be of importance.
- Describe the circumstances where financial statements should, and should not, be adjusted.

Candidates were also required to recommend the accounting treatment for a series of events after the reporting period.

5.1 Events requiring adjustment

The standard requires adjustment of assets and liabilities in certain circumstances.

An entity shall adjust the amounts recognised in its financial statements to reflect **adjusting events** after the reporting period. An entity shall not adjust the amounts recognised in its financial statements to reflect non-adjusting events after the reporting period. *(IAS 10)*

An **example** of additional evidence which becomes available after the reporting period is where a **customer goes bankrupt, thus confirming that the trade account receivable balance at the year end is uncollectible.** In relation to **going concern**, the standard states that, where operating results and the financial position have deteriorated after the reporting period, it may be necessary to reconsider whether the going concern assumption is appropriate in the preparation of the financial statements.

Examples of **adjusting events** would be:

- evidence of a permanent diminution in property value prior to the year end
- sale of inventory after the reporting period for less than its carrying value at the year end
- insolvency of a customer with a balance owing at the year end
- amounts received or paid in respect of legal or insurance claims which were in negotiation at the year end
- determination after the year end of the sale or purchase price of assets sold or purchased before the year end
- evidence of a permanent diminution in the value of a long-term investment prior to the year end
- discovery of error or fraud which shows that the financial statements were incorrect

5.2 Events not requiring adjustment

The standard then looks at events which do **not** require adjustment.

The standard gives the following examples of events which do **not** require adjustments:

- acquisition of, or disposal of, a subsidiary after the year end
- announcement of a plan to discontinue an operation
- major purchases and disposals of assets
- destruction of a production plant by fire after the reporting period
- announcement or commencing implementation of a major restructuring
- share transactions after the reporting period
- litigation commenced after the reporting period

But note that, while they may be non-adjusting, some events after the reporting period will require **disclosure**.

If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions of users taken on the basis of the financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:

(a) the nature of the event; and
(b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

(IAS 10)

The **example** given by the standard of such an event is where the **value of an investment falls between the end of the reporting period and the date the financial statements are authorised** for issue. The fall in value represents circumstances during the current period, not conditions existing at the end of the previous reporting period, so it is not appropriate to adjust the value of the investment in the financial statements. Disclosure is an aid to users, however, indicating 'unusual changes' in the state of assets and liabilities after the reporting period.

The rule for **disclosure** of events occurring after the reporting period which relate to conditions that arose after that date, is that disclosure should be made if non-disclosure would hinder the user's ability to make **proper evaluations** and decisions based on the financial statements. An example might be the acquisition of another business.

Chapter Roundup

- IAS 8 deals with changes in accounting estimates, changes in accounting policies and errors.
- Changes in accounting policy are applied **retrospectively**.
- Changes in accounting estimate are **not** applied retrospectively.
- Prior period errors must be corrected **retrospectively**.
- IFRS 5 requires assets 'held for sale' to be presented separately in the statement of financial position. It sets out the criteria for recognising a **discontinued operation**.
- IAS 10 sets out the criteria for recognising **events occurring after the reporting date**.

Quick Quiz

1 How should a prior period error be corrected under IAS 8?
2 Give the circumstances when a change in accounting policy might be required.
3 When can a non-current asset be classified as held for sale?
4 How should an asset held for sale be measured?
5 How does IFRS 5 define a discontinued operation?

Answers to Quick Quiz

1 By adjusting the opening balance of retained earnings (Para 3.2)

2 (a) The change is required by an IFRS; or

(b) The change will result in a **more appropriate presentation** of events or transactions in the financial statements of the entity, providing more reliable and relevant information.

3 (a) The asset must be **available for immediate sale** in its present condition

(b) Its sale must be **highly probable** (ie significantly more likely than not).

4 At the lower of carrying amount and fair value less costs of disposal

5 See Key Term para 4.6

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q22	Examination	40	72 mins

18

Earnings per share

Topic list	Syllabus reference
1 IAS 33 Earnings per share	C2
2 Basic EPS	C2
3 Effect on EPS of changes in capital structure	C2
4 Diluted EPS	C2
5 Presentation, disclosure and other matters	C2

Introduction

Earnings per share (EPS) is widely used by investors as a measure of a company's performance and is of particular importance in:

(a) **Comparing the results** of a company over a **period of time.**

(b) **Comparing the performance** of one company's equity against the performance of **another company's equity**, and also against the returns obtainable from loan stock and other forms of investment.

The purpose of any earnings yardstick is to achieve as far as possible clarity of meaning, comparability between one company and another, one year and another, and attributability of profits to the equity shares. IAS 33 *Earnings per share* goes some way to ensuring that all these aims are achieved.

Study guide

C2	**Earnings per share**
(a)	Recognise the importance of comparability in relation to the calculation of earnings per share (EPS) and its importance as a stock market indicator
(b)	Explain why the trend of EPS may be a more accurate indicator of performance than a company's profit trend
(c)	Define earnings
(d)	Calculate the EPS in the following circumstances – basic EPS – where there has been a bonus issue of shares/stock split during the year, and – where there has been a rights issue of shares during the year
(e)	Explain the relevance to existing shareholders of the diluted EPS, and describe the circumstances that will give rise to a future dilution of the EPS
(f)	Compute the diluted EPS in the following circumstances: – Where convertible debt or preference shares are in issue – Where share options and warrants exist
(g)	Identify anti-dilutive circumstances

1 IAS 33 Earnings per share

FAST FORWARD

Earnings per share is a measure of the amount of profits earned by a company for each ordinary share. Earnings are profits after tax and preference dividends.

Exam focus point

IAS 33 is a fairly straightforward standard. You would be advised to make sure that you follow all the calculations and discussion points through so that you can tackle any questions that do come up.

1.1 Objective

The objective of IAS 33 is to improve the **comparison** of the performance of different entities in the same period and of the same entity in different accounting periods by prescribing methods for determining the number of shares to be included in the calculation of earnings per share and other amounts per share and by specifying their presentation.

1.2 Definitions

The following definitions are given in IAS 33 and IAS 32.

Key terms

- **Ordinary shares**: an equity instrument that is subordinate to all other classes of equity instruments.
- **Potential ordinary share:** a financial instrument or other contract that may entitle its holder to ordinary shares.
- **Options, warrants and their equivalents**: financial instruments that give the holder the right to purchase ordinary shares. *(IAS 33)*
- **Financial instrument**: any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.
- **Equity instrument**: any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. *(IAS 32)*

1.2.1 Ordinary shares

There may be more than one class of ordinary shares, but ordinary shares of the same class will have the same rights to receive dividends. Ordinary shares participate in the net profit for the period **only after other types of shares**, eg preference shares.

1.2.2 Potential ordinary shares

IAS 33 identifies the following examples of financial instruments and other contracts generating potential ordinary shares.

(a) **Debt or equity instruments**, including preference shares, that are convertible into ordinary shares
(b) **Share warrants and options**
(c) **Employee plans** that allow employees to receive ordinary shares as part of their remuneration and other share purchase plans
(d) Shares that would be issued upon the satisfaction of **certain conditions** resulting from contractual arrangements, such as the purchase of a business or other assets

1.3 Scope

IAS 33 has the following scope restrictions.

(a) Only companies with (potential) ordinary shares which are **publicly traded** need to present EPS (including companies in the process of being listed).
(b) EPS need only be presented on the basis of **consolidated results** where the parent's results are shown as well.
(c) Where companies **choose** to present EPS, even when they have no (potential) ordinary shares which are traded, they must do so in accordance with IAS 33.

2 Basic EPS

FAST FORWARD

Basic EPS is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.

2.1 Measurement

Basic EPS should be calculated by dividing the **net profit** or loss for the period attributable to ordinary shareholders by the **weighted average number of ordinary shares** outstanding during the period.

$$\text{Basic EPS} = \frac{\text{Net profit /(loss) attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

2.2 Earnings

Earnings includes **all items of income and expense** (including tax and non-controlling interests) *less* the results of discontinued operations where these are presented, *less* net profit attributable to **preference shareholders**, including preference dividends.

Preference dividends deducted from net profit consist of:

(a) Preference dividends on non-cumulative preference shares declared in respect of the period
(b) The full amount of the required preference dividends for cumulative preference shares for the period, *whether or not* they have been declared (*excluding* those paid/declared during the period in respect of previous periods)

Note. In an exam question any preference shares will be redeemable and the dividend will already have been accounted for under finance costs.

2.3 Per share

The number of ordinary shares used should be the weighted average number of ordinary shares during the period. This figure (for all periods presented) should be **adjusted for events**, other than the conversion of potential ordinary shares, that have changed the number of shares outstanding without a corresponding change in resources.

The **time-weighting factor** is the number of days the shares were outstanding compared with the total number of days in the period; a reasonable approximation is usually adequate.

2.4 Example: weighted average number of shares

Justina Co, a listed company, has the following share transactions during 20X7.

Date	*Details*	*Shares issued*
1 January 20X7	Balance at beginning of year	170,000
31 May 20X7	Issue of new shares for cash	80,000
31 December 20X7	Balance at year end	250,000

Required

Calculate the weighted average number of shares outstanding for 20X7.

Solution

The weighted average number of shares can be calculated in two ways:

(a) (170,000 × 5/12) + (250,000 × 7/12) = 216,666 shares
(b) (170,000 × 12/12) + (80,000 × 7/12) = 216,666 shares

2.5 Consideration

Shares are usually included in the weighted average number of shares from the **date consideration is receivable** which is usually the date of issue. The treatment for the issue of ordinary shares in different circumstances is as follows.

Consideration	Start date for inclusion
In exchange for cash	When cash is receivable
On the voluntary reinvestment of dividends on ordinary or preferred shares	The dividend payment date
As a result of the conversion of a debt instrument to ordinary shares	Date interest ceases accruing
In place of interest or principal on other financial instruments	Date interest ceases accruing
In exchange for the settlement of a liability of the entity	The settlement date
As consideration for the acquisition of an asset other than cash	The date on which the acquisition is recognised
For the rendering of services to the entity	As services are rendered

Ordinary shares issued as **purchase consideration** in an acquisition should be included as of the date of acquisition because the acquired entity's results will also be included from that date.

If ordinary shares are **partly paid**, they are treated as a fraction of an ordinary share to the extent they are entitled to dividends relative to fully paid ordinary shares.

Contingently issuable shares (including those subject to recall) are included in the computation when all necessary conditions for issue have been satisfied.

Question

Flame Co is a company with a called up and paid up capital of 100,000 ordinary shares of $1 each and 20,000 10% redeemable preference shares of $1 each.

The gross profit was $200,000 and trading expenses were $50,000. Flame Co paid the required preference share dividend and an ordinary dividend of 42c per share. The tax charge for the year was estimated at $40,000.

Calculate basic EPS for the year.

Answer

FLAME CO
TRADING RESULTS FOR YEAR TO 31 DECEMBER

	$
Gross profit	200,000
Expense (50,000 + 2,000 preference dividend)	(52,000)
Profit before tax	148,000
Income tax expense	(40,000)
Profit for the year	108,000

EARNINGS PER SHARE

$$\frac{108,000}{100,000} = 108c$$

3 Effect on EPS of changes in capital structure

FAST FORWARD

You should know how to calculate **basic EPS** and how to deal with related complications (issue of shares for cash, bonus issues, rights issues).

3.1 Introduction

We looked at the effect of issues of new shares on basic EPS above. In these situations, the corresponding figures for EPS for the previous year will be comparable with the current year because, as the weighted average number of shares has risen, there has been a **corresponding increase in resources**. Money has been received when shares were issued. It is assumed that shares are issued at full market price.

3.2 Example: earnings per share with a new issue

On 30 September 20X2, Boffin Co made an issue at full market price of 1,000,000 ordinary shares. The company's accounting year runs from 1 January to 31 December. Relevant information for 20X1 and 20X2 is as follows.

	20X2	*20X1*
Shares in issue as at 31 December	9,000,000	8,000,000
Profits after tax and preference dividend	$3,300,000	$3,280,000

Required

Calculate the EPS for 20X2 and the corresponding figure for 20X1.

Solution

	20X2	20X1
Weighted average number of shares		
8 million × 9/12	6,000,000	
9 million × 3/12	2,250,000	
	8,250,000	8,000,000
Earnings	$3,300,000	$3,280,000
EPS	40 cents	41 cents

In spite of the increase in total earnings by $20,000 in 20X2, the EPS is not as good as in 20X1, because there was extra capital employed for the final 3 months of 20X2.

There are other events, however, which change the number of shares outstanding, **without a corresponding change in resources**. In these circumstances it is necessary to make adjustments so that the current and prior period EPS figures are comparable.

Four such events are considered by IAS 33.

(a) **Capitalisation or bonus issue** (sometimes called a stock dividend)
(b) Bonus element in any other issue, eg a **rights issue** to existing shareholders
(c) **Share split**
(d) **Reverse share split** (consolidation of shares)

3.3 Capitalisation/bonus issue and share split/reverse share split

These two types of event can be considered together as they have a similar effect. In both cases, ordinary shares are issued to existing shareholders for **no additional consideration**. The number of ordinary shares has increased without an increase in resources.
This problem is solved by **adjusting the number of ordinary shares outstanding before the event** for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported.

3.4 Example: earnings per share with a bonus issue

Greymatter Co had 400,000 shares in issue, until on 30 September 20X2 it made a bonus issue of 100,000 shares. Calculate the EPS for 20X2 and the corresponding figure for 20X1 if total earnings were $80,000 in 20X2 and EPS for 20X1 was 18.75c. The company's accounting year runs from 1 January to 31 December.

Solution

	20X2	
Earnings	$80,000	
Shares at 1 January	400,000	
Bonus issue	100,000	
	500,000	shares
EPS	16c	

The number of shares for 20X1 must also be adjusted if the figures for EPS are to remain comparable.

The EPS for 20X1 is therefore restated as:

$$18.75c \times \frac{400}{500} = 15c$$

3.5 Rights issue

A rights issue of shares is an issue of new shares to existing shareholders **at a price below the current market value**. The offer of new shares is made on the basis of x new shares for every y shares currently held; eg a 1 for 3 rights issue is an offer of 1 new share at the offer price for every 3 shares currently held. This means that there is a bonus element included.

To arrive at figures for EPS when a rights issue is made, we need to calculate first of all the **theoretical ex-rights price**. This is a weighted average value per share, and is perhaps explained most easily with a numerical example.

3.6 Example: theoretical ex-rights value

Suppose that Egghead Co has 10,000,000 shares in issue. It now proposes to make a 1 for 4 rights issue at a price of $3 per share. The market value of existing shares on the final day before the issue is made is $3.50 (this is the 'with rights' value). What is the theoretical ex-rights price per share?

Solution

	$
Before issue 4 shares, value $3.50 each	14.00
Rights issue 1 share, value $3	3.00
Theoretical value of 5 shares	17.00

Theoretical ex-rights value = $\frac{\$17.00}{5}$ = $3.40 per share

Note that this calculation can alternatively be performed using the total value and number of outstanding shares.

3.7 Procedures

The procedures for calculating the EPS for the current year and a corresponding figure for the previous year are as follows.

(a) The **EPS for the corresponding previous period** should be multiplied by the following fraction. (*Note.* The market price on the last day of quotation is taken as the fair value immediately prior to exercise of the rights, as required by the standard.)

Formula to learn

$$\frac{\text{Theoretical ex - rights fair value per share}}{\text{Fair value per share immediately before the exercise of rights (cum rights price)}}$$

(b) To obtain the **EPS for the current year** you should:

(i) Multiply the number of shares before the rights issue by the fraction of the year before the date of issue and by the following fraction

Formula to learn

$$\frac{\text{Fair value per share immediately before the exercise of rights (cum rights price)}}{\text{Theoretical ex - rights fair value per share}}$$

(ii) Multiply the number of shares after the rights issue by the fraction of the year after the date of issue and add to the figure arrived at in (i)

The total earnings should then be divided by the total number of shares so calculated.

3.8 Example: earnings per share with a rights issue

Brains Co had 100,000 shares in issue, but then makes a 1 for 5 rights issue on 1 October 20X2 at a price of $1. The market value on the last day of quotation with rights was $1.60.

Calculate the EPS for the year ended 31 December 20X2 and the corresponding figure for 20X1 given total earnings of $50,000 in 20X2 and $40,000 in 20X1.

Solution

Calculation of theoretical ex-rights price:

	$
Before issue 5 shares, value × $1.60	8.00
Rights issue 1 share, value × $1.00	1.00
Theoretical value of 6 shares	9.00

Theoretical ex-rights price = $\frac{\$9}{6} = \$1.50$

EPS for 20X1

EPS as calculated before taking into account the rights issue = 40c ($40,000 divided by 100,000 shares).

EPS = $\frac{1.50}{1.60} \times 40c = 37\frac{1}{2}c$

(Remember: This is the corresponding value for 20X1 which will be shown in the financial statements for Brains Co at the end of 20X2.)

EPS for 20X2

Number of shares before the rights issue was 100,000. 20,000 shares were issued.

Stage 1:	$100{,}000 \times {}^{9}/_{12} \times \frac{1.60}{1.50}$	80,000
Stage 2:	$120{,}000 \times {}^{3}/_{12}$	30,000
		110,000

EPS = $\frac{\$50{,}000}{110{,}000} = 45\frac{1}{2}c$

The figure for total earnings is the actual earnings for the year.

Question — Rights issue

Marcoli Co has produced the following net profit figures for the years ending 31 December.

	$m
20X6	1.1
20X7	1.5
20X8	1.8

On 1 January 20X7 the number of shares outstanding was 500,000. During 20X7 the company announced a rights issue with the following details.

Rights:	1 new share for each 5 outstanding (100,000 new shares in total)
Exercise price:	$5.00
Last date to exercise rights:	1 March 20X7

The market (fair) value of one share in Marcoli immediately prior to exercise on 1 March 20X7 = $11.00.

Required

Calculate the EPS for 20X6, 20X7 and 20X8.

Answer

Computation of theoretical ex-rights price

This computation uses the total fair value and number of shares.

$$\frac{\text{Fair value of all outstanding shares} + \text{total received from exercise of rights}}{\text{No shares outstanding prior to exercise} + \text{no shares issued in exercise}}$$

$$= \frac{(\$11.00 \times 500{,}000) + (\$5.00 \times 100{,}000)}{500{,}000 + 100{,}000} = \$10.00$$

Computation of EPS

		20X6	*20X7*	*20X8*
		$	$	$
20X6	EPS as originally reported $\frac{\$1{,}100{,}000}{500{,}000}$	2.20		
20X6	EPS restated for rights issue $\frac{\$1{,}100{,}000}{500{,}000} \times \frac{10}{11}$ (or $2.20 \times \frac{10}{11}$)	2.00		
20X7	EPS including effects of rights issue $\frac{\$1{,}500{,}000}{(500{,}000 \times 2/12 \times 11/10) + (600{,}000 \times 10/12)}$		2.54	
20X8	EPS = $\frac{\$1{,}800{,}000}{600{,}000}$			3.00

Exam focus point

You should know how to deal with the effect on EPS of bonus and rights issues and be able to calculate diluted EPS.

4 Diluted EPS

FAST FORWARD

Diluted EPS is calculated by adjusting the net profit due to continuing operations attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.

4.1 Introduction

At the end of an accounting period, a company may have in issue some **securities** which do not (at present) have any 'claim' to a share of equity earnings, but **may give rise to such a claim in the future**. These securities include:

(a) A **separate class of equity shares** which at present is not entitled to any dividend, but will be entitled after some future date

(b) **Convertible loan stock** or **convertible preferred shares** which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate

(c) **Options** or **warrants**

In such circumstances, the future number of ordinary shares in issue might increase, which in turn results in a fall in the EPS. In other words, a **future increase** in the **number of ordinary shares will cause a dilution or 'watering down' of equity**, and it is possible to calculate a **diluted earnings per share** (ie the

EPS that would have been obtained during the financial period if the dilution had already taken place). This will indicate to investors the possible effects of a future dilution.

4.2 Earnings

The earnings calculated for basic EPS should be based on **continuing operations** and adjusted by the **post-tax** (including deferred tax) effect of:

(a) Any **dividends** on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS

(b) **Interest recognised** in the period for the dilutive potential ordinary shares (convertible debt)

(c) Any **other changes in income or expenses** (fees or discount) that would result from the conversion of the dilutive potential ordinary shares

The conversion of some potential ordinary shares may lead to changes in **other income or expenses**. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit-sharing plan. When calculating diluted EPS, the net profit or loss for the period is adjusted for any such consequential changes in income or expense.

4.3 Per share

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic EPS plus the weighted average number of ordinary shares that would be issued on the conversion of all the **dilutive potential ordinary shares** into ordinary shares.

It should be assumed that dilutive ordinary shares were converted into ordinary shares at the **beginning of the period** or, if later, at the actual date of issue. There are two other points.

(a) The computation assumes the most **advantageous conversion rate** or exercise rate from the standpoint of the holder of the potential ordinary shares.

(b) **Contingently issuable** (potential) ordinary shares are treated as for basic EPS; if the conditions have not been met, the number of contingently issuable shares included in the computation is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not allowed if the conditions are not met when the contingency period expires.

4.4 Example: diluted EPS

In 20X7 Farrah Co had a basic EPS of 105c based on earnings of $105,000 and 100,000 ordinary $1 shares. It also had in issue $40,000 15% convertible loan stock which is convertible in two years' time at the rate of 4 ordinary shares for every $5 of stock. The rate of tax is 30%.

Required

Calculate the diluted EPS.

Solution

Diluted EPS is calculated as follows.

Step 1 **Number of shares**: the additional equity on conversion of the loan stock will be 40,000 × 4/5 = 32,000 shares

Step 2 **Earnings**: Farrah Co will save interest payments of $6,000 (40,000 × 15%) but this increase in profits will be taxed. Hence the earnings figure may be recalculated:

(105,000 + (6,000 × 70%)) = $109,200

Step 3 **Calculation**: Diluted EPS = $\frac{\$109,200}{132,000}$ = 82.7c

Step 4 **Dilution**: the dilution in earnings would be 105c – 82.7c = 22.3c per share.

Question — Diluted EPS

Ardent Co has 5,000,000 ordinary shares of 25 cents each in issue, and also had in issue in 20X4:

(a) $1,000,000 of 14% convertible loan stock, convertible in three years' time at the rate of 2 shares per $10 of stock;

(b) $2,000,000 of 10% convertible loan stock, convertible in one year's time at the rate of 3 shares per $5 of stock.

The total earnings in 20X4 were $1,750,000.

The rate of income tax is 35%.

Required

Calculate the basic EPS and diluted EPS.

Answer

(a) Basic EPS = $\frac{\$1{,}750{,}000}{5 \text{ million}}$ = 35 cents

(b) We must decide which of the potential ordinary shares (ie the loan stocks) are dilutive (ie would decrease the EPS if converted).

For the 14% loan stock, incremental EPS = $\frac{0.65 \times \$140{,}000}{200{,}000 \text{ shares}}$ = 45.5c

For the 10% loan stock, incremental EPS = $\frac{0.65 \times \$200{,}000}{1.2\text{m shares}}$ = 10.8c

The effect of converting the 14% loan stock is therefore to **increase** the EPS figure, since the incremental EPS of 45.5c is greater than the basic EPS of 35c. The 14% loan stock is not dilutive and is therefore excluded from the diluted EPS calculation.

The 10% loan stock is dilutive.

Diluted EPS = $\frac{\$1.75\text{m} + \$0.13\text{m}}{5\text{m} + 1.2\text{m}}$ = 30.3c

Note:
The calculation of DEPS should always be based on the **maximum** number of shares that can be issued. For instance, if the 14% loan stock above had the following conversion rights:

20X5: 4 shares per $10

20X6: 3 shares per $10

20X7: 2 shares per $10

DEPS would be calculated at 4 shares per $10.

4.5 Treatment of options

It should be assumed that options are exercised and that the assumed proceeds would have been received from the issue of shares at **fair value**. Fair value for this purpose is calculated on the basis of the average price of the ordinary shares during the period. Options are brought into the dilution calculation in the year in which they are issued.

Options and other share purchase arrangements are dilutive when they would result in the issue of ordinary shares for **less than fair value**. The amount of the dilution is fair value less the issue price. In order to calculate diluted EPS, each transaction of this type is treated as consisting of two parts.

(a) A contract to issue a certain number of ordinary shares at their **average market price** during the period. These shares are fairly priced and are assumed to be neither dilutive nor antidilutive. They are **ignored** in the computation of diluted earnings per share.

(b) A contract to issue the remaining ordinary shares for **no consideration**. Such ordinary shares generate no proceeds and have no effect on the net profit attributable to ordinary shares outstanding. Therefore such shares are **dilutive** and they are added to the number of ordinary shares outstanding in the computation of diluted EPS.

To the extent that **partly paid shares** are not entitled to participate in dividends during the period, they are considered the equivalent of **warrants** or **options**.

Question

EPS 2

Brand Co has the following results for the year ended 31 December 20X7.

Net profit for year	$1,200,000
Weighted average number of ordinary shares outstanding during year	500,000 shares
Average fair value of one ordinary share during year	$20.00
Weighted average number of shares under option during year	100,000 shares
Exercise price for shares under option during year	$15.00

Required

Calculate both basic and diluted earnings per share.

Answer

	Per share	*Earnings* $	*Shares*
Net profit for year		1,200,000	
Weighted average shares outstanding during 20X7			500,000
Basic earnings per share	2.40		
Number of shares under option			100,000
Number of shares that would have been issued			
At fair value: (100,000 × $15.00/$20.00)			(75,000) *
Diluted earnings per share	2.29	1,200,000	525,000

* The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration.

4.6 Dilutive potential ordinary shares

According to IAS 33, potential ordinary shares should be treated as dilutive when, and only when, their conversion to ordinary shares would **decrease net profit per share** from continuing operations. This point was illustrated in the question above.

4.7 Restatement

If the number of ordinary or potential ordinary shares outstanding **increases** as a result of a capitalisation, bonus issue or share split, or decreases as a result of a reverse share split, the calculation of basic and diluted EPS for all periods presented should be **adjusted retrospectively**.

If these changes occur **after the reporting date** but before the financial statements are authorised for issue, the calculations per share for the financial statements and those of any prior period should be based on the **new number of shares** (and this should be disclosed).

In addition, basic and diluted EPS of all periods presented should be adjusted for the effects of **material errors**, and adjustments resulting from **changes** in **accounting policies**, dealt with in accordance with IAS 8.

An entity **does not restate diluted EPS** of any prior period for changes in the assumptions used or for the conversion of potential ordinary shares into ordinary shares outstanding.

Entities are encouraged to disclose a description of ordinary share transactions or potential ordinary share transactions, other than capitalisation issues and share splits, which occur **after the reporting date** when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions (see IAS 10). Examples of such transactions include the following:

(a) Issue of shares for cash
(b) Issue of shares when the proceeds are used to repay debt or preferred shares outstanding at the reporting date
(c) Redemption of ordinary shares outstanding
(d) Conversion or exercise of potential ordinary shares, outstanding at the reporting date, into ordinary shares
(e) Issue of warrants, options or convertible securities
(f) Achievement of conditions that would result in the issue of contingently issuable shares

EPS amounts are not adjusted for such transactions occurring after the reporting date because such transactions **do not affect the amount of capital used** to produce the net profit or loss for the period.

5 Presentation, disclosure and other matters

FAST FORWARD

IAS 33 contains a number of requirements on presentation and disclosure.

5.1 Presentation

Basic and diluted EPS should be presented by an entity in the statement of profit or loss and other comprehensive income for each class of ordinary share that has a different right to share in the net profit for the period. The basic and diluted EPS should be presented with **equal prominence** for all periods presented.

Disclosure must still be made where the EPS figures (basic and/or diluted) are **negative** (ie a loss per share).

5.2 Disclosure

An entity should disclose the following.

(a) The amounts used as the **numerators** in calculating basic and diluted EPS, and a **reconciliation** of those amounts to the net profit or loss for the period
(b) The weighted average number of ordinary shares used as the **denominator** in calculating basic and diluted EPS, and a **reconciliation** of these denominators to each other.

5.3 Alternative EPS figures

An entity may present **alternative EPS figures if it wishes**. However, IAS 33 lays out certain rules where this takes place.

(a) The weighted average number of shares as calculated under IAS 33 **must** be used.

(b) A **reconciliation** must be given if necessary between the component of profit used in the alternative EPS and the line item for profit reported in the statement of profit or loss and other comprehensive income.

(c) Basic and diluted EPS must be shown with **equal prominence**.

5.4 Significance of earnings per share

Earnings per share (EPS) is one of the most frequently quoted statistics in financial analysis. Because of the widespread use of the price earnings **(P/E) ratio** as a yardstick for investment decisions, it became increasingly important. It is certainly true that EPS gives a more accurate picture of the actual return to investors than reported profits, which do not show the dilutive effect of share issues.

Reported and forecast EPS can, through the P/E ratio, have a **significant effect on a company's share price**. Thus, a share price might fall if it looks as if EPS is going to be low.

There are a number of reasons why EPS should not be used to determine the value of a company's shares. IAS 33 concentrates on the **denominator** of EPS – ie the number of shares. However, it is more difficult to regulate the **numerator** – earnings. Reported earnings can be affected by a number or factors – choice of accounting policy, asset valuation, taxation issues. Directors who want to present favourable EPS can find ways to boost reported earnings, as happened with Enron.

EPS has also served as a means of assessing the **stewardship and management** role performed by company directors and managers. Remuneration packages might be linked to EPS growth, thereby increasing the pressure on management to improve EPS. The danger of this, however, is that management effort may go into distorting results to produce a favourable EPS.

It should also be noted that EPS takes no account of other issues that affect whether a company is worth investing in, such as its risk profile and its investment requirements. Nevertheless, the market is sensitive to EPS.

Chapter Roundup

- **Earnings per share** is a measure of the amount of profits earned by a company for each ordinary share. Earnings are profits after tax and preferred dividends.
- **Basic EPS** is calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period.
- You should know how to calculate **basic EPS** and how to deal with related complications (issue of shares for cash, bonus issues, rights issues).
- **Diluted EPS** is calculated by adjusting the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding for the effects of all dilutive potential ordinary shares.
- **IAS 33** contains a number of requirements on presentation and disclosure.

Quick Quiz

1 How is basic EPS calculated?

2 Give the formula for the 'bonus element' of a rights issue.

3 Define 'dilutive potential ordinary share'.

4 Which numerator is used to decide whether potential ordinary shares are dilutive?

5 Why is the numerator adjusted for convertible bonds when calculating diluted EPS?

Answers to Quick Quiz

1 $$\frac{\text{Net profit/(loss) attributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares outstanding during the period}}$$

2 $$\frac{\text{Actual cum – rights price}}{\text{Theoretical ex – rights price}}$$

3 See Para 4.1

4 Net profit from continuing operations only.

5 Because the issue of shares will affect earnings (the interest will no longer have to be paid).

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q23	Examination	20	36 mins

19 Miscellaneous standards: related party disclosures and segment reporting

Topic list	Syllabus reference
1 IAS 24 *Related party disclosures*	C5
2 IFRS 8 *Operating segments*	C6

Introduction

In this chapter we look at two standards.

IAS 24 requires disclosure on related party transactions during the period in order to give a better indication of performance.

IFRS 8 on segment reporting requires quoted entities to provide additional information on their results in order for more detailed analysis to be possible.

Study Guide

C5	**Related party disclosures**
(a)	Define and apply the definition of related parties in accordance with international accounting standards
(b)	Describe the potential to mislead users when related party transactions are accounted for
(c)	Explain the disclosure requirements for related party transactions
C6	**Operating segments**
(a)	Discuss the usefulness and problems associated with the provision of segment information
(b)	Define an operating segment
(c)	Identify a reportable segment (including applying the aggregation criteria and quantitative thresholds)

1 IAS 24 *Related party disclosures*

FAST FORWARD

IAS 24 is primarily a disclosure standard. It is concerned to improve the quality of information provided by published accounts and also to strengthen their stewardship roles.

In the absence of information to the contrary, it is assumed that a reporting entity has **independent discretionary power** over its resources and transactions and pursues its activities independently of the interests of its individual owners, managers and others. Transactions are presumed to have been undertaken on an **arm's length basis**, ie on terms such as could have obtained in a transaction with an external party, in which each side bargained knowledgeably and freely, unaffected by any relationship between them.

These assumptions may not be justified when **related party relationships** exist, because the requisite conditions for competitive, free market dealings may not be present. While the parties may endeavour to achieve arm's length bargaining the very nature of the relationship may preclude this occurring.

1.1 Objective

This is the related parties issue and IAS 24 tackles it by ensuring that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by material transactions with them. In other words, this is a standard which is primarily concerned with **disclosure**.

1.2 Scope

The standard requires disclosure of related party transactions and outstanding balances in the **separate financial statements** of a parent, venturer or investor presented in accordance with IAS 27 as well as in consolidated financial statements.

An entity's financial statements disclose related party transactions and outstanding balances with other entities in a group. **Intragroup** transactions and balances are **eliminated** in the preparation of consolidated financial statements.

1.3 Definitions

The following important definitions are given by the standard. Note that the definitions of **control** and **significant influence** are now the same as those given in IASs 27, 28 and 31. The definitions of related parties were revised in 2009.

Key terms

Related party. A related party is a person or entity that is related to the entity that is preparing its financial statements.

(a) A **person** or a close member of that person's family is **related** to a reporting entity if that person:

  (i) has control or joint control over the reporting entity;

  (ii) has significant influence over the reporting entity; or

  (iii) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

(b) An **entity** is related to a reporting entity if any of the following conditions applies:

  (i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

  (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

  (iii) Both entities are joint ventures of the same third party.

  (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

  (v) The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

  (vi) The entity is controlled or jointly controlled by a person identified in (a).

  (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

Related party transaction. A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control over these policies. Significant ownership may be gained by share ownership, statute or agreement.

Joint control is the contractually agreed sharing of control over an economic activity.

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Close members of the family of an individual are those family members who may be expected to influence, or be influenced by, that individual in their dealings with the entity. They may include:

(a) the individual's domestic partner and children;
(b) children of the domestic partner; and
(c) dependants of the individual or the domestic partner. *(IAS 24)*

The most important point to remember here is that, when considering each possible related party relationship, attention must be paid to the **substance of the relationship, not merely the legal form**.

IAS 24 lists the following which are **not necessarily related parties:**

(a) **Two entities simply because they have a director or other key management in common** (notwithstanding the definition of related party above, although it is necessary to consider how that director would affect both entities)

(b) **Two venturers, simply because they share joint control over a joint venture**.

(c) Certain other bodies, simply as a result of their **role in normal business dealings** with the entity

    (i) Providers of finance
    (ii) Trade unions
    (iii) Public utilities
    (iv) Government departments and agencies

(d) **Any single customer, supplier, franchisor, distributor, or general agent** with whom the entity transacts a significant amount of business, simply by virtue of the resulting economic dependence.

1.4 Exemption for government-related entities

Before the 2009 revision of IAS 24, if a government controlled or significantly influenced an entity, the entity was required to disclose information about all transactions with other entities controlled, or significantly influenced, by the same government. The revised standard still requires disclosures that are significant to users of the financial statements, but **eliminates the need to disclose information that is costly to gather, and of less value to users**. It achieves this by limiting disclosure required to transactions that are individually or collectively significant.

1.5 Disclosure

As noted above, IAS 24 is almost entirely concerned with disclosure and its provisions are meant to **supplement** those disclosure requirements required by national company legislation and other IASs (particularly IASs 1, 22, 27 and 28).

The standard lists some **examples** of transactions that are disclosed if they are with a related party:

- Purchases or sales of goods (finished or unfinished)
- Purchases or sales of property and other assets
- Rendering or receiving of services
- Leases
- Transfer of research and development
- Transfers under licence agreements
- Provision of finance (including loans and equity contributions in cash or in kind)
- Provision of guarantees and collateral security
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.

Relationships between **parents and subsidiaries** must be **disclosed irrespective** of **whether** any **transactions** have **taken place between** the related parties. An entity must disclose the **name** of its **parent** and, if different, the **ultimate controlling party**. This will enable a reader of the financial statements to be able to form a view about the effects of a related party relationship on the reporting entity.

If neither the parent nor the ultimate controlling party produces financial statements available for public use, the name of the next most senior parent that does so shall also be disclosed.

An entity should disclose key management personnel compensation in total for various categories:

(a) Items of a similar nature may be **disclosed in aggregate** *unless* separate disclosure is necessary for an understanding of the effect on the financial statements.

(b) Disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions are made only if such disclosures can be substantiated.

1.6 Section summary

IAS 24 is primarily concerned with **disclosure**. You should learn the following.

- **Definitions**: these are very important
- Relationships covered
- Relationships that **may not** necessarily be between related parties
- **Disclosures**: again, very important, representing the whole purpose of the standard

Question — Related parties

Fancy Feet Co is a UK company which supplies handmade leather shoes to a chain of high street shoe shops. The company is also the sole importer of some famous high quality Greek stoneware which is supplied to an upmarket shop in London's West End.

Fancy Feet Co was set up 30 years ago by Georgios Kostades who left Greece when he fell out with the military government. The company is owned and run by Mr Kostades and his three children.

The shoes are purchased from a French company, the shares of which are owned by the Kostades Family Trust (Monaco).

Required

Identify the financial accounting issues arising out of the above scenario.

Answer

Issues

(a) The basis on which Fancy Feet trades with the Greek supplier and the French company owned by the Kostades family trust.

(b) Whether the overseas companies trade on commercial terms with the UK company or do the foreign entities control the UK company.

(c) Who owns the Greek company: is this a related party under the provisions of IAS 24?

(d) Should the nature of trade suggest a related party controls Fancy Feet Co? Detailed disclosures will be required in the accounts.

Try this longer question on related parties.

Question — RP Group

Discuss whether the following events would require disclosure in the financial statements of the RP Group, a public limited company, under IAS 24 *Related party disclosures*.

The RP Group, merchant bankers, has a number of subsidiaries, associates and joint ventures in its group structure. During the financial year to 31 October 20X9 the following events occurred.

(a) The company agreed to finance a management buyout of a group company, AB, a limited company. In addition to providing loan finance, the company has retained a 25% equity holding in the company and has a main board director on the board of AB. RP received management fees, interest payments and dividends from AB.

(b) On 1 July 20X9, RP sold a wholly owned subsidiary, X, a limited company, to Z, a public limited company. During the year RP supplied X with secondhand office equipment and X leased its factory from RP. The transactions were all contracted for at market rates.

(c) The retirement benefit scheme of the group is managed by another merchant bank. An investment manager of the group retirement benefit scheme is also a non-executive director of the RP Group and received an annual fee for his services of $25,000 which is not material in the group context. The company pays $16m per annum into the scheme and occasionally transfers assets into the scheme. In 20X9, property, plant and equipment of $10m were transferred into the scheme and a recharge of administrative costs of $3m was made.

Answer

(a) IAS 24 does not require disclosure of transactions between companies and providers of finance in the ordinary course of business. As RP is a merchant bank, no disclosure is needed between RP and AB. However, RP owns 25% of the equity of AB and it would seem significant influence exists (IAS 28, **greater than 20% existing holding means significant influence is presumed**) and therefore AB could be an associate of RP. IAS 24 regards associates as related parties.

The decision as to associate status depends upon the ability of RP to exercise significant influence especially as the other 75% of votes are owned by the management of AB.

Merchant banks tend to regard companies which would qualify for associate status as trade investments since the relationship is designed to provide finance.

IAS 28 presumes that a party owning or able to exercise control over 20% of voting rights is a related party. So an investor with a 25% holding and a director on the board would be expected to have significant influence over operating and financial policies in such a way as to inhibit the pursuit of separate interests. If it can be shown that this is not the case, there is no related party relationship.

If it is decided that there is a related party situation then **all material transactions** should be disclosed including **management fees**, **interest, dividends and the terms of the loan**.

(b) **IAS 24 does *not* require intragroup transactions and balances eliminated** on **consolidation to be disclosed**. IAS 24 does not deal with the situation where an undertaking becomes, or ceases to be, a subsidiary during the year.

Best practice indicates that related party transactions should be disclosed for the period when X was not part of the group. Transactions between RP and X should be disclosed between 1 July 20X9 an 31 October 20X9 but transactions prior to 1 July will have been eliminated on consolidation.

There is no related party relationship between RP and Z since it is a normal business transaction unless either parties interests have been influenced or controlled in some way by the other party.

(c) **Employee retirement benefit schemes** of the reporting entity are included in the IAS 24 definition of **related parties**.

The contributions paid, the non current asset transfer ($10m) and the charge of administrative costs ($3m) must be disclosed.

The **pension investment manager** would **not normally** be **considered** a **related party. However,** the manager is **key management personnel** by virtue of his **non-executive directorship**.

Directors are deemed to be related parties by IAS 24, and the manager receives a $25,000 fee. IAS 24 requires the disclosure of **compensation paid to key management personnel** and the fee falls within the definition of compensation. Therefore, it must be disclosed.

2 IFRS 8 *Operating segments*

FAST FORWARD

An important aspect of reporting financial performance is **segment reporting**. This is covered by IFRS 8 *Operating segments*.

Exam focus point

This area was last tested in June 2013 with a requirement to explain how to identify reportable segments.

2.1 Introduction

Large entities produce a wide range of products and services, often in several different countries. Further information on how the overall results of entities are made up from each of these product or geographical areas will help the users of the financial statements. This is the reason for **segment reporting**.

- The entity's **past performance** will be better understood
- The entity's **risks and returns** may be better assessed
- More **informed judgements** may be made about the entity as a whole

Risks and returns of a **diversified, multi-national company** can only be assessed by looking at the individual risks and rewards attached to groups of products or services or in different groups of products or services or in different geographical areas. These are subject to differing rates of profitability, opportunities for growth, future prospects and risks.

In recent years this has proved to be a relatively controversial area of financial reporting. The difficulty for standard-setters is twofold. First, one must decide what constitutes a segment (eg should segments be identified on the basis of geography or their operational function?). Second, financial reporting requirements must balance the relevance of the segmental information provided in the context of the particular reporting entity, with the need for information to be comparable across many different types of entity. A balance needs to be struck between allowing management to exercise sufficient **judgement** for the information provided to be **relevant**, and the need to minimise creative accounting to provide information that is both **reliable** and **comparable**.

Segment reporting is covered by IFRS 8 *Operating segments*, which replaced IAS 14 *Segment reporting* in 2006 as part of the process of convergence between IFRS and US GAAP.

2.2 Objective

An entity must disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

2.3 Scope

Only entities whose **equity or debt securities are publicly traded** (ie on a stock exchange) need disclose segment information. In group accounts, only **consolidated** segmental information needs to be shown. (The statement also applies to entities filing or in the process of filing financial statements for the purpose of issuing instruments.)

2.4 Definition of operating segment

FAST FORWARD

Reportable segments are **operating segments** or aggregation of operating segments that meet specified criteria.

You need to learn this definition, as it is crucial to the standard.

Key term

Operating segment. This is a component of an entity:

(a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity)

(b) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and

(c) For which discrete financial information is available.

IFRS 8

The term 'chief operating decision maker' identifies a function, not necessarily a manager with a specific title. That function is to allocate resources and to assess the performance of the entity's operating segments

2.5 Aggregation

Two or more operating segments may be **aggregated** if the segments have **similar economic characteristics**, and the segments are similar in *each* of the following respects:

- The **nature of the products or services**
- The **nature of the production process**
- The **type or class of customer for their products or services**
- The **methods used to distribute their products or provide their services**, and
- If applicable, the **nature of the regulatory environment**

2.6 Determining reportable segments

FAST FORWARD

IFRS 8 adopts a **management approach** to determining operating segments.

An entity must report separate information about **each operating segment** that:

(a) Has been identified as meeting the **definition of an operating segment**; and

(b) Segment total is **10% or more of total**:

(i) **Revenue** (internal and external), or
(ii) **Profit** of **all segments not reporting a loss** (or all segments in loss if greater), or
(iii) **Assets**

At least **75% of the entity's total external revenue** must be reported by the operating segments identified. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

Two or more operating segments **below** the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in a **majority** of the aggregation criteria above.

Operating segments that do not meet **any of the quantitative thresholds** may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

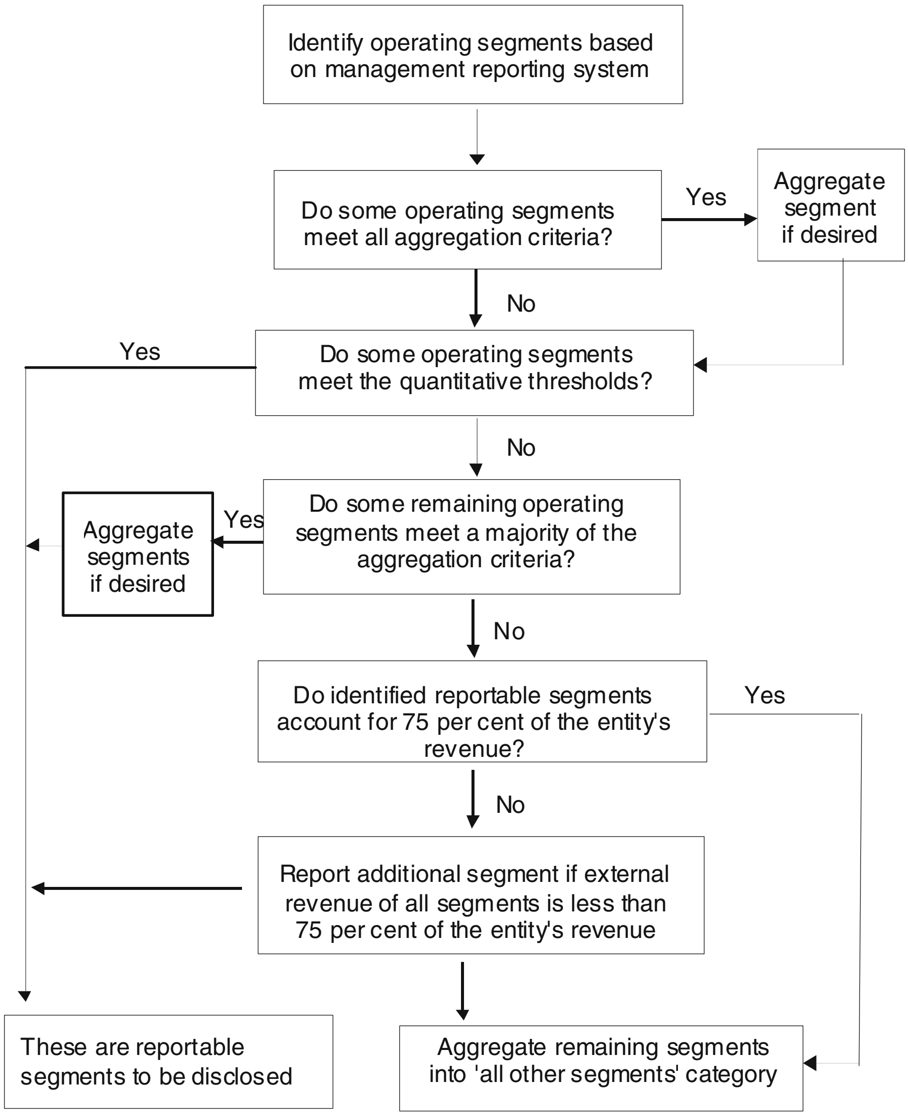
2.6.1 Decision tree to assist in identifying reportable segments

FAST FORWARD

An operating segment is a component of an entity:

– That engages in business activities where it earns revenues and incurs expenses
– Whose results are regularly reviewed by the chief operating decision maker
– For which discrete, financial information is available.

The following decision tree will assist in identifying reportable segments.



2.7 Disclosures

IFRS 8 disclosures are of:

- Operating segment profit or loss
- Segment assets
- Segment liabilities
- Certain income and expense items

Disclosures are also required about the revenues derived from products and services and about the countries in which revenues are earned or assets held, even if that information is not used by management in making decisions.

In April 2009 under the annual IFRS Improvements, IFRS 8 was amended to state that segment assets no longer have to be disclosed if they are not reported internally. This was effective from January 2010.

2.8 Key changes from IAS 14 Segment reporting

(a) IFRS 8 **converges with US GAAP** by adopting SFAS 131 Disclosures about segments of an enterprise and related information.

(b) The FASB managerial approach to identifying segments based on an internal organisation structure is used rather than the IAS 14 risk and returns approach.

(c) There is **no primary and secondary** (either business or geographical) **segment disclosure** hierarchy.

(d) There is no longer a requirement for more than 50% of revenue to be external for a segment to be reported separately.

(e) **Revenue, profit and assets** for reportable segment testing are **no longer defined**. The basis used depends on the information reported to the chief operating decision maker.

(f) The **level of compulsory segment disclosure** is **lower**, as only profit or loss and total assets are required figures. Other items are only disclosed if included in the figures reviewed by or regularly provided to the chief operating decision maker.

(g) The **scope of disclosure is widened** to include finance income, finance cost and income tax expense (if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker).

(h) New disclosures are required on **factors used to determine reportable segments** and types of products and services.

(i) **Geographical disclosures** are required on a **country by country** basis if material.

(j) There is no requirement to disclose capital expenditure on a geographical basis.

2.9 Advantages and disadvantages of the old and new segment definition approaches

	Advantages	Disadvantages
'Risks and Returns' approach (old IAS 14)	• The information can be reconciled to the financial statements • It is a consistent method • The method helps to highlight the profitability, risks and returns of an identifiable segment	• Segment determination is the responsibility of directors and is subjective • Management may report segments which are not consistent for internal reporting and control purposes making its usefulness questionable
'Managerial' approach (IFRS 8)	• It is cost effective because the marginal cost of reporting segmental data will be low. • Users can be sure that the segment data reflects the operational strategy of the business	• The information may be commercially sensitive. • The segments may include operations with different risks and returns

2.10 Criticisms of IFRS 8

(a) Some commentators have criticized the 'management approach' as leaving segment identification **too much to the discretion of the entity.**

(b) The management approach may mean that financial statements of different entities are **not comparable.**

(c) Segment determination is the responsibility of directors and is **subjective.**

(d) Management may report segments which are **not consistent** for internal reporting and control purposes, making its usefulness questionable.

(e) For accounting periods beginning on or after 1 January 2005 listed entities within the EU are required to use adopted international standards in their consolidated financial statements. The **EU has not yet adopted IFRS 8** and until it does IAS 14 will continue to apply here. Some stakeholders believe the standard to be flawed due to the amount of discretion it gives to management.

(f) **Geographical information** has been **downgraded.** It could be argued that this **breaks the link between a company and its stakeholders.**

(g) There is **no defined measure** of segment profit or loss.

2.11 Example: determining operating segments

Jesmond, a retail and leisure group, has three businesses operating in different parts of the world. Jesmond reports to management on the basis of region. The results of the regional segments for the year ended 31 December 20X9 are as follows.

	Revenue		*Segment results*	*Segment*	*Segment*
Region	*External*	*Internal*	*profit/(loss)*	*assets*	*liabilities*
	$m	$m	$m	$m	$m
European	200	3	(10)	300	200
North America	300	2	60	800	300
Other regions	500	5	105	2,000	1,400

There were no significant intra-group balances in the segment assets and liabilities. The retail outlets and leisure centres are located in capital cities in the various regions, and the company sets individual performance indicators for each hotel based on its city location.

Required

Discuss the principles in IFRS 8 *Operating segments* for the determination of a company's reportable operating segments and how these principles would be applied for Jesmond plc using the information given above.

Solution

IFRS 8 *Operating segments* states that an operating segment is a reported **separately** if:

(i) **It meets the definition of an operating segment**, ie:

  (1) It engages in business activities from which it may **earn revenues** and **incur expenses**,

  (2) Its operating results are **regularly reviewed by the entity's chief operating decision maker** to make decisions about resources to be allocated to the segment and assess its performance, and

  (3) **Discrete financial information** is available for the segment,

and

(ii) It exceeds **at least one** of the following quantitative thresholds:

  (1) Reported revenue is **10% or more the combined revenue** of all operating segments (external and intersegment), or

  (2) The absolute amount of its reported profit or loss is **10% or more of the greater of,** in absolute amount, **all operating segments not reporting a loss, and all operating segments reporting a loss**, or

  (3) Its assets are **10% or more of the total assets** of all operating segments.

At least **75% of total external revenue** must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds).

Two or more operating segments **below** the thresholds may be aggregated to produce a reportable segment if the segments have similar economic characteristics, and the segments are similar in a **majority** of the following aggregation criteria:

(1) The nature of the products and services
(2) The nature of the production process
(3) The type or class of customer for their products or services
(4) The methods used to distribute their products or provide their services
(5) If applicable, the nature of the regulatory environment

Operating segments that do not meet **any of the quantitative thresholds** may be reported separately if management believes that information about the segment would be useful to users of the financial statements.

For Jesmond, **the thresholds are as follows**.

(i) Combined revenue is $1,010 million, so 10% is $101 million.
(ii) Combined reported profit is $165 million, so 10% is $16.5 million.
(iii) Combined reported loss is $10 million, so 10% is $1 million.
(iv) Total assets are $3,100 million, so 10% is $310 million.

The **North America segment** meets the criteria, passing all three tests. Its combined revenue is $302 million; its reported profit is $60 million, and its assets are $800 million.

The **European segment** also meets the criteria, but only marginally. Its reported revenue, at $203 million is greater than 10% of combined revenue, and only one of the tests must be satisfied. However, its loss of $10 million is less than the greater of 10% of combined profit and 10% of combined loss, so it fails this test. It also fails the assets test, as its assets, at $300 million are less than 10% of combined assets ($310 million).

IFRS 8 requires further that at least 75% of total external revenue must be reported by operating segments. Currently, only 50% is so reported. Additional operating segments (the 'other regions') must be identified until this 75% threshold is reached.

IFRS 8 may result in a **change** to the way Jesmond's operating segments are reported, depending on how segments were previously identified.

2.12 Section summary

IFRS 8 is a **disclosure standard**.

- **Segment reporting** is necessary for a better understanding and assessment of:
  - Past performance
  - Risks and returns
  - Informed judgements
- IFRS 8 adopts the **managerial approach** to identifying segments
- The standard gives guidance on how segments should be **identified** and **what information should be disclosed** for each

It also sets out **requirements for related disclosures** about products and services, geographical areas and major customers.

Chapter Roundup

- **IAS 24** is primarily a disclosure standard. It is concerned to improve the quality of information provided by published accounts and also to strengthen their stewardship roles.
- An important aspect of reporting financial performance is **segment reporting**. This is covered by IFRS 8 *Operating segments*.
- Reportable segments are **operating segments** or aggregation of operating segments that meet specified criteria.
- IFRS 8 adopts a **management approach** to determining operating segments.
- An operating segment is a component of an entity:
  - That engages in business activities where it earns revenues and incurs expenses
  - Whose results are regularly reviewed by the chief operating decision maker
  - For which discrete, financial information is available.

Quick Quiz

1. What is a related party transaction?
2. A managing director of a company is a related party. *True / False*?
3. Give two examples of situations in which a related party relationship does not necessarily exist.
4. What are the criteria to determine if an operating segment is reportable?

Answers to Quick Quiz

1 A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

2 True. A member of the key management personnel of an entity is a related party of that entity.

3 See Paragraph 1.3

4 See Paragraph 2.6

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q24	Examination	20	36 mins

20 Reporting for small and medium-sized entities

Topic list	Syllabus reference
1 Background	C7
2 Application of IFRS to smaller entities	C7
3 *IFRS for Small and Medium-Sized Entities*	C7
4 Consequences, good and bad	C7

Introduction

Concentrate on Section 1 – this is the most important for your exam.

You should be aware that smaller entities may have different accounting needs from the larger entities, but IFRS are generally designed for larger ones. This chapter gives you the background you need to set you thinking about whether a one-size-fits-all set of standards is adequate.

Study guide

C7	**Reporting requirements of small and medium entities (SMEs)**
(a)	Outline the principal considerations in developing a set of accounting standards for SMEs.
(b)	Discuss solutions to the problem of differential financial reporting.
(c)	Discuss the reasons why the IFRS for SMEs does not address certain topics

1 Background

FAST FORWARD

IFRSs are designed for entities quoted on the world's capital markets. However, **most entities are small or medium sized**.

Exam focus point

This topic has a separate syllabus section, and is a recent addition to the syllabus. It was also the subject of an article which is available online at:

http://www.accaglobal.com/content/dam/acca/global/PDF-students/acca/tech/sa_mar10_IFRS_SMEs_INT.pdf

1.1 Scope of IFRS

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are **not intended to be applied to immaterial items, nor are they retrospective**. Each individual IFRS lays out its scope at the beginning of the standard.

1.2 Application

Within each individual country **local regulations** govern, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies and/or professional accountancy bodies in the country concerned.

The IFRSs **concentrate on essentials** and are designed not to be too complex, otherwise they would be impossible to apply on a worldwide basis.

IFRSs do not override local regulations on financial statements. Accounting bodies that are members of the IASB should simply disclose the fact where IFRSs are complied with in all material respects. Members of the IASB in individual countries will attempt to persuade local authorities, where current regulations deviate from IFRSs, that the benefits of harmonisation make local change worthwhile.

2 Application of IFRS to smaller entities

FAST FORWARD

Various approaches were proposed to deal with the so-called **Big GAAP/Little GAAP divide**.

2.1 Big GAAP/little GAAP divide

In most countries the majority of companies or other types of entity are **very small**. They are generally owned and managed by one person or a family. The owners have invested their own money in the business and there are no outside shareholders to protect.

Large entities, by contrast, particularly companies listed on a stock exchange, may have shareholders who have invested their money, possibly through a pension fund, with no knowledge whatever of the company. These shareholders need protection and the regulations for such companies need to be more stringent.

It could therefore be argued that company accounts should be of two types.

(a) 'Simple' ones for small companies with fewer regulations and disclosure requirements
(b) 'Complicated' ones for larger companies with extensive and detailed requirements

This is sometimes called the **big GAAP/little GAAP divide**.

2.2 Possible solutions

There are two approaches to overcoming the big GAAP/little GAAP divide:

1 Differential reporting, ie producing new reduced standards specifically for smaller companies, such as the UK FRSSE or the IFRS for SMEs (see below).

2 Providing exemptions for smaller companies from some of the requirements of existing standards.

2.3 Differential reporting

A one-size-fits-all framework does not generate relevant, and useful information, even if this information is reliable:

(a) The costs may not be justified for the more limited needs of users of SME accounts.

(b) The purpose of the financial statements and the use to which they are put will not be the same as for listed companies.

Differential reporting overcomes this by tailoring the reporting requirements to the entity. The main characteristic that distinguishes SMEs from other entities is the degree of public accountability. For example, a listed company or a public utility, or a company such as a bank, which holds assets in a fiduciary capacity might be regarded as publicly accountable. Despite the name SME, size is not the only or even the main criterion. (This was the position the IASB adopted – see below.)

Differential reporting may have drawbacks in terms of reducing comparability between small and larger company accounts.

Furthermore, problems may arise where entities no longer meet the criteria to be classified as small.

2.4 Exemptions from IFRS

Some IFRSs do not have any bearing on small company accounts, for example, a company with equity not quoted on a stock exchange has no need to comply with IAS 33 *Earnings per share*. Also an entity with a small local market, may find IFRS 8 *Operating segments* to be superfluous.

Other standards always have an impact. In particular, almost all small companies will be affected by the IFRSs on:

- Property, plant and equipment
- Inventories
- Presentation of financial statements
- Events occurring after the reporting period
- Taxes on income
- Revenue
- Provisions and contingencies

Does this mean that companies below a certain size should be exempt from other IFRSs? An alternative approach would be to reduce the exposure of small companies to IFRSs on a **standard by standard basis**. For those 'core' standards listed above, small companies would be required to follow all or most of their provisions. For more complicated standards, small companies would face nothing but very brief general obligations.

It is difficult to see how the IASB could impose any kind of specific size limits to define small companies if such an approach were adopted. Instead, it might specify that size limits which are already given in national legislation or standards could be adopted for the purpose.

To a certain extent (see IAS 33 and IFRS 8 above) partial exemption already applies. Indeed, an IFRS for Small and Medium-sized Entities that applies some but not all of the requirements of existing IFRS achieves this aim.

2.4.1 Cost of compliance

If the cost of compliance exceeds the benefits to users, an entity may decide not to follow an IFRS. This applies to all reporting entities, not just smaller ones. However, smaller entities are more likely to make use of this exception.

For example, impairment reviews can be time-consuming and a smaller entity may not have sufficient staff to spare to carry out these reviews.

2.4.2 Materiality

Another point to note is that IFRSs apply to **material** items. In the case of smaller entities, the amount that is material may be very small in monetary terms. However, the effect of not reporting that item may be material in that it would mislead users of the financial statements. A case in point is IAS 24 *Related Party Disclosures*. Smaller entities may well rely on trade with relatives of the directors/shareholders and this needs to be disclosed.

3 *IFRS for Small and Medium-sized Entities*

FAST FORWARD

Published in July 2009, the *IFRS for Small and Medium-sized Entities* aims to simplify financial reporting for SMEs by omitting irrelevant topics, reducing guidance and disclosure and eliminating choice. It also simplifies some of the recognition and measurement principles.

The *IFRS for Small and Medium-Sized Entities* (IFRS for SMEs) was published in 2009. It is only 230 pages, and has simplifications that reflect the needs of users of SMEs' financial statements and cost-benefit considerations. It is designed to facilitate financial reporting by small and medium-sized entities in a number of ways:

(a) It provides significantly less guidance than full IFRS.

(b) Many of the principles for recognising and measuring assets, liabilities, income and expenses in full IFRSs are simplified.

(c) Where full IFRSs allow accounting policy choices, the IFRS for SMEs allows only the easier option.

(d) Topics not relevant to SMEs are omitted.

(e) Significantly fewer disclosures are required.

(f) The standard has been written in clear language that can easily be translated.

3.1 Scope

The IFRS is suitable for all entities except those whose securities are publicly traded and financial institutions such as banks and insurance companies. It is the first set of international accounting requirements developed specifically for small and medium-sized entities (SMEs). Although it has been prepared on a similar basis to IFRS, it is a stand-alone product and will be updated on its own timescale.

The IFRS will be revised only once every three years. It is hoped that this will further reduce the reporting burden for SMEs.

There are no quantitative thresholds for qualification as a SME; instead, the scope of the IFRS is determined by a test of public accountability. As with full IFRS, it is up to legislative and regulatory authorities and standard setters in individual jurisdictions to decide who is permitted or required to use the IFRS for SMEs.

3.2 Effective date

The IFRS for SMEs does not contain an effective date; this is determined in each jurisdiction. The IFRS will be revised only once every three years. It is hoped that this will further reduce the reporting burden for SMEs.

3.3 Accounting policies

For situations where the IFRS for SMEs does not provide specific guidance, it provides a hierarchy for determining a suitable accounting policy. An SME must consider, in descending order:

- The guidance in the IFRS for SMEs on similar and related issues.
- The definitions, recognition criteria and measurement concepts in Section 2 *Concepts and Pervasive Principles* of the standard.

The entity also has the option of considering the requirements and guidance in full IFRS dealing with similar topics. However, it is under no obligation to do this, or to consider the pronouncements of other standard setters.

3.4 Overlap with full IFRS

In the following areas, the recognition and measurement guidance in the IFRS for SMEs is like that in the full IFRS.

- Provisions and contingencies
- Hyperinflation accounting
- Events after the end of the reporting period

3.5 Omitted topics

The IFRS for SMEs does not address the following topics that are covered in full IFRS.

- Earnings per share
- Interim financial reporting
- Segment reporting
- Classification for non-current assets (or disposal groups) as held for sale

3.6 Examples of options in full IFRS not included in the IFRS for SMEs

- Revaluation model for intangible assets and property, plant and equipment
- Choice between cost and fair value models for investment property (measurement depends on the circumstances)
- Options for government grants

3.7 Principal recognition and measurement simplifications

(a) **Financial instruments**

Financial instruments meeting specified criteria are measured at cost or amortised cost.
All others are measured at fair value through profit or loss. The procedure for derecognition has been simplified, as have hedge accounting requirements.

(b) **Goodwill and other indefinite-life intangibles**

These are always amortised over their estimated useful life (or ten years if it cannot be estimated).

(c) **Investments in associates and joint ventures**

These can be measured at cost, but fair value must be used if there is a published price quotation.

(d) **Research and development costs and borrowing costs** must be expensed.

(e) **Property, plant and equipment and intangibles**

There is no need to review residual value, useful life and depreciation method unless there is an indication that they have changed since the most recent reporting date.

(f) **Defined benefit plans**

All actuarial gains and losses are to be recognised immediately (in profit or loss or other comprehensive income). All past service costs are to be recognised immediately in profit or loss. To measure the defined benefit obligation, the projected unit credit method must be used.

Note. IAS 19 has been revised and has incorporated these simplifications.

(g) **Income tax**

When published, the *IFRS for SMEs* said to follow the ED *Income tax,* which simplified IAS 12. This ED has been withdrawn, but it is likely that the treatment of income tax will be simpler in the *IFRS for SMEs* when this is replaced.

(h) **Available-for-sale assets**

There is no separate available-for-sale classification; holding an asset or group of assets for sale is an indicator of impairment.

(i) **Biological assets**

SMEs are to use the cost-depreciation-impairment model unless the fair value is readily determinable, in which case the fair value through profit or loss model is required.

(j) **Equity-settled share-based payment**

If observable market prices are not available to measure the fair value of the equity-settled share-based payment, the directors' best estimate is used.

4 Consequences, good and bad

FAST FORWARD

There is **no perfect solution** to the Big GAAP/Little GAAP divide. It remains to be seen how well *the IFRS for SMEs* will work in practice.

4.1 Likely effect

Because there is no supporting guidance in the IFRS for SMEs, it is likely that differences will arise from full IFRS, even where the principles are the same. Most of the exemptions in the IFRS for SMEs are on grounds of cost or undue effort. However, despite the practical advantages of a simpler reporting framework, there will be costs involved for those moving to IFRS – even a simplified IFRS – for the first time.

4.2 Advantages and disadvantages of the IFRS for SMEs

4.2.1 Advantages

(a) It is virtually a '**one stop shop**'.
(b) It is **structured according to topics**, which should make it practical to use.
(c) It is written in an **accessible style**.
(d) There is **considerable reduction in disclosure requirements**.
(e) Guidance **not relevant** to private entities is **excluded**.

4.2.2 Disadvantages

(a) It does **not** focus on the **smallest companies**.

(b) The scope extends to 'non-publicly accountable' entities. Potentially, the **scope is too wide**.

(c) The standard will be **onerous** for **small companies**.

(d) **Further simplifications** could be made. These might include:

   (i) Amortisation for goodwill and intangibles

   (ii) No requirement to value intangibles separately from goodwill on a business combination

   (iii) No recognition of deferred tax

   (iv) No measurement rules for equity-settled share-based payment

   (v) No requirement for consolidated accounts (as for EU small and medium-sized entities currently)

   (vi) All leases accounted for as operating leases with enhanced disclosures

   (vii) Fair value measurement when readily determinable without undue cost or effort.

Chapter Roundup

- IFRSs are designed for entities quoted on the world's capital markets. However, **most entities are small or medium sized**.
- Various approaches were proposed to deal with the so-called **Big GAAP/Little GAAP divide**.
- Published in July 2009, the *IFRS for Small and Medium-sized Entities* aims to simplify financial reporting for SMEs by omitting irrelevant topics, reducing guidance and disclosure and eliminating choice. It also simplifies some of the recognition and measurement principles.
- There is **no perfect solution** to the Big GAAP/Little GAAP divide. It remains to be seen how well the *IFRS for SMEs* will work in practice.

Quick Quiz

1 What is differential financial reporting?

2 The treatment of provisions is simpler in the *IFRS for SMEs* than in IAS 37. *True or false?*

3 The financial instruments categories 'held-to-maturity' and 'available-for-sale' are not included in the *IFRS for SMEs. True or false?*

4 Proportionate consolidation of investments in jointly controlled entities is allowed in:

A IAS 31 only
B IAS 31 and the *IFRS for SMEs*
C The *IFRS for SMEs* only
D It is not allowed anywhere

Answers to Quick Quiz

1 Producing new reduced standards specifically for smaller companies.

2 False. Provisions are one area in which the recognition and measurement guidance in the *IFRS for SMEs* is like that in the full IFRS.

3 True, and once IFRS 9 is in force they will no longer be available in full IFRS.

4 D. It is not allowed at all. IFRS 11 has been issued to reflect this, but the *IFRS for SMEs* was there first.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q25	Examination	20	36 mins

P A R T D

Preparation of external financial reports for combined entities and joint arrangements

21

Constitution of a group

Topic list	Syllabus reference
1 Group accounts	D1
2 IFRS 10 Consolidated financial statements	D1
3 Content of group accounts and group structure	D1
4 Group accounts: the related parties issue	C5

Introduction

Consolidation is an extremely important area of your syllabus.

The key to consolidation questions in the examination is to adopt a logical approach and to practise as many questions as possible.

In this chapter we will look at the major definitions in consolidation. These matters are fundamental to your comprehension of group accounts, so make sure you can understand them and then **learn them**.

Study guide

D1	**Preparation of group consolidated external reports**
(a)	Explain the concept of a group and the purpose of preparing consolidated financial statements
(b)	Explain and apply the definition of subsidiary companies
(c)	Identify the circumstances and reasoning when subsidiaries should be excluded from consolidated financial statements
(e)	Explain the need for using coterminous year-ends and uniform accounting policies and preparing consolidated financial statements and describe how it is achieved in practice
C5	**Related party disclosures**
(b)	Describe the potential to mislead users when related party transactions are accounted for

1 Group accounts

FAST FORWARD

Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a **group**. The controlling company, called the **parent** or **holding company**, will own some or all of the shares in the other companies, called **subsidiaries**.

1.1 Introduction

There are many reasons for businesses to operate as groups; for the goodwill associated with the names of the subsidiaries, for tax or legal purposes and so forth. In many countries, company law requires that the results of a group should be presented as a whole. Unfortunately, it is not possible simply to add all the results together and this chapter and those following will teach you how to **consolidate** all the results of companies within a group.

In traditional accounting terminology, a **group of companies** consists of a **parent company** and one or more **subsidiary companies** which are controlled by the parent company.

1.2 Accounting standards

We will be looking at four accounting standards in this and the next three chapters.

- IFRS 3 *Business combinations*
- IFRS 10 *Consolidated financial statements*
- IFRS 13 *Fair value measurement*
- IAS 28 *Investments in associates and joint ventures*

These standards are all concerned with different aspects of group accounts, but there is some overlap between them, particularly between IFRS 3 and IFRS 10.

In this and the next chapter we will concentrate on IFRS 10, which cover the basic group definitions and consolidation procedures of a parent-subsidiary relationship. First of all, however, we will look at all the important definitions involved in group accounts, which **determine how to treat each particular type of investment** in group accounts.

1.3 Definitions

We will look at some of these definitions in more detail later, but they are useful here in that they give you an overview of all aspects of group accounts.

Exam focus point

All the definitions relating to group accounts are extremely important. You must **learn them** and **understand** their meaning and application.

Key terms

- **Control**. An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through power over the investee. *(IFRS 10)*
- **Power**. Existing rights that give the current ability to direct the relevant activities of the investee. *(IFRS 10)*
- **Subsidiary**. An entity that is controlled by another entity. *(IFRS 10)*
- **Parent**. An entity that controls one or more subsidiaries. *(IFRS 10)*
- **Group**. A parent and all its subsidiaries. *(IFRS 10)*
- **Associate**. An entity over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture. *(IFRS 10)*
- **Significant influence** is the power to participate in the financial and operating policy decisions of an investee but is not control or joint control over those policies. *(IAS 28)*

We can summarise the different types of investment *and* the required accounting for them as follows.

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control	Full consolidation
Associate	Significant influence	Equity accounting (see Chapter 11)
Investment which is none of the above	Asset held for accretion of wealth	As for single company accounts per IFRS 9

1.4 Investments in subsidiaries

The important point here is **control**. In most cases, this will involve the holding company or parent owning a majority of the ordinary shares in the subsidiary (to which normal voting rights are attached). There are circumstances, however, when the parent may own only a minority of the voting power in the subsidiary, *but* the parent still has control.

IFRS 10 provides a definition of control (above) and identifies three separate elements of control:

An investor controls an investee if and only if it has all of the following:

a) **Power** over the investee

b) Exposure to, or rights to, **variable returns** from its involvement with the investee; and

c) **The ability to use its power** over the investee to affect the amount of the investor's returns

If there are changes to one or more of these three elements of control, then an investor should reassess whether it controls an investee.

Power (as defined under Key Terms) can be obtained directly from ownership of the majority of voting rights or can be derived from other rights, such as:

- Rights to appoint, reassign or remove key management personnel who can direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities
- Rights to direct the investee to enter into, or veto changes to, transactions for the benefit of the investor
- Other rights, such as those specified in a management contract

Exam focus point

You should learn the contents of the above paragraph as you may be asked to apply them in the exam.

It is of course quite possible that several different parties may have influence over an entity, but only one may have control at any one time. Thus several investors may have a current ability to participate in the direction of the entity's activities, but this may only constitute 'significant influence' rather than 'power'.

These other investors would therefore have an associate, but the investor with the power to direct has control and therefore a subsidiary.

1.4.1 Example: control

Alpha owns 40% of the equity capital of Beta. The remaining 60% of Beta's shares are owned by a broad range of investors, each of whom owns less than 0.5% of Beta's shares. None of the other shareholders has any arrangements to consult with any of the others or to make collective decisions. Since it acquired its stake in Beta, Alpha has actively participated in establishing its operating and financial policies.

Answer

IFRS 10 states that an investor controls an investee if the investor has the following.

Power over the investee. At 40%, Alpha's shareholding is at least 80 times larger than the next biggest investor (at less than 0.5%). The other shareholders do not consult or make decisions together, so there is no question of them operating as a larger single unit. Therefore Alpha is in a position of power over Beta.

Exposure to variable returns from its involvement with the investee. Alpha's shareholding entitles it to dividends which will vary with the level of Beta's profits.

Ability to use its power to affect returns. Alpha effectively has effective control of the board of directors, and is thus able to control the operating and financial policies of Beta. This will affect Beta's profits and in turn any dividends received by Alpha.

1.4.2 Accounting treatment in group accounts

IFRS 10 requires a parent to present consolidated financial statements, in which the accounts of the parent and subsidiary (or subsidiaries) are combined and presented **as a single entity**.

1.5 Investments in associates

This type of investment is something less than a subsidiary, but more than a simple investment. The key criterion here is **significant influence**. This is defined as the 'power to participate', but *not* to 'control' (which would make the investment a subsidiary).

Significant influence can be determined by the holding of voting rights (usually attached to shares) in the entity. IAS 28 states that if an investor holds **20% or more** of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, *unless* it can be clearly shown that this is not the case.

Significant influence can be presumed *not* to exist if the investor holds **less than 20%** of the voting power of the investee, unless it can be demonstrated otherwise.

The **existence of significant influence** is evidenced in one or more of the following ways.

(a) Representation on the **board of directors** (or equivalent) of the investee
(b) Participation in the **policy making process**
(c) **Material transactions** between investor and investee
(d) Interchange of management personnel
(e) Provision of essential technical information

IAS 28 requires the use of the **equity method** of accounting for investments in associates. This method will be explained in detail in Chapter 24.

Question — **Treatments**

The section summary after this question will give an augmented version of the table given in Paragraph 1.3 above. Before you look at it, see if you can write out the table yourself.

1.6 Section summary

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control (> 50% rule)	Full consolidation (IFRS 10)
Associate	Significant influence (20%+ rule)	Equity accounting (IAS 28)
Investment which is none of the above	Asset held for accretion of wealth	As for single company accounts (IFRS 9)

2 IFRS 10 Consolidated financial statements

FAST FORWARD

IFRS 10 requires a parent to present **consolidated** financial statements.

2.1 Definitions

Key term

Consolidated financial statements. The financial statements of a group presented as those of a single economic entity. *(IFRS 10)*

When a parent issues consolidated financial statements, it should consolidate **all subsidiaries**, both foreign and domestic. The first step in any consolidation is to identify the subsidiaries using the definition as set out in Section 1.3 above.

2.2 Power

Power is defined as **existing rights that give the current ability to direct the relevant activities of the investee**. There is no requirement for that power to have been exercised.

Relevant activities may include:

- Selling and purchasing goods or services
- Managing financial assets
- Selecting, acquiring and disposing of assets
- Researching and developing new products and processes
- Determining a funding structure or obtaining funding.

In some cases assessing power is straightforward, for example, where power is obtained directly and solely from having the majority of voting rights or potential voting rights, and as a result the ability to direct relevant activities.

In other cases, assessment is more complex and more than one factor must be considered. IFRS 10 gives the following examples of **rights**, other than voting or potential voting rights, which individually, or alone, can give an investor power.

- Rights to appoint, reassign or remove key management personnel who can direct the relevant activities
- Rights to appoint or remove another entity that directs the relevant activities
- Rights to direct the investee to enter into, or veto changes to transactions for the benefit of the investor
- Other rights, such as those specified in a management contract.

IFRS 10 suggests that the **ability** rather than contractual right to achieve the above may also indicate that an investor has power over an investee.

An investor can have power over an investee even where other entities have significant influence or other ability to participate in the direction of relevant activities.

2.2.1 Returns

An investor must have exposure, or rights, to **variable returns** from its involvement with the investee in order to establish control.

This is the case where the investor's returns from its involvement have the potential to vary as a result of the investee's performance.

Returns may include:

- Dividends
- Remuneration for servicing an investee's assets or liabilities
- Fees and exposure to loss from providing credit support
- Returns as a result of achieving synergies or economies of scale through an investor combining use of their assets with use of the investee's assets

2.2.2 Link between power and returns

In order to establish control, an investor must be able to use its power to affect its returns from its involvement with the investee. This is the case even where the investor delegates its decision making powers to an agent.

2.3 Exemption from preparing group accounts

A parent **need not present** consolidated financial statements if and only if all of the following hold:

(a) The parent is itself a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements

(b) Its securities are **not publicly traded**

(c) It is **not in the process of issuing securities** in public securities markets; and

(d) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards

A parent that does not present consolidated financial statements must comply with the IAS 27 rules on separate financial statements (discussed later in this section).

2.4 Potential voting rights

An entity may own share warrants, share call options, or other similar instruments that are **convertible into ordinary shares** in another entity. If these are exercised or converted they may give the entity voting power or reduce another party's voting power over the financial and operating policies of the other entity (potential voting rights). The **existence and effect** of potential voting rights, including potential voting rights held by another entity, should be considered when assessing whether an entity has control over another entity (and therefore has a subsidiary). Potential voting rights are considered only if the rights are **substantive** (meaning that the holder must have the practical ability to exercise the right).

In assessing whether potential voting rights give rise to control, the investor should consider the **purpose and design of the instrument**. This includes an assessment of the various terms and conditions of the instrument as well as the investor's apparent expectations, motives and reasons for agreeing to those terms and conditions.

2.5 Exclusion of a subsidiary from consolidation

Where a parent controls one or more subsidiaries, IFRS 10 requires that consolidated financial statements are prepared to include **all subsidiaries, both foreign and domestic** other than:

- Those held for sale in accordance with IFRS 5
- Those held under such long-term restrictions that control cannot be operated.

The rules on exclusion of subsidiaries from consolidation are necessarily strict, because this is a common method used by entities to manipulate their results. If a subsidiary which carries a large amount of debt can be excluded, then the gearing of the group as a whole will be improved. In other words, this is a way of taking debt **out of the consolidated statement of financial position**.

IFRS 10 is clear that a subsidiary should not be excluded from consolidation simply because it is loss making or its business activities are dissimilar from those of the group as a whole. IFRS 10 rejects the latter argument: exclusion on these grounds is not justified because better information can be provided about such subsidiaries by consolidating their results and then giving additional information about the different business activities of the subsidiary, eg under IFRS 8 *Operating segments*.

2.6 Different reporting dates

In most cases, all group companies will prepare accounts to the same reporting date. One or more subsidiaries may, however, prepare accounts to a different reporting date from the parent and the bulk of other subsidiaries in the group.

In such cases the subsidiary may prepare additional statements to the reporting date of the rest of the group, for consolidation purposes. If this is not possible, the subsidiary's accounts may still be used for the consolidation, *provided that* the gap between the reporting dates is **three months or less**.

Where a subsidiary's accounts are drawn up to a different accounting date, **adjustments should be made** for the effects of significant transactions or other events that occur between that date and the parent's reporting date.

2.7 Uniform accounting policies

Consolidated financial statements should be prepared using **the same accounting policies** for like transactions and other events in similar circumstances.

Adjustments must be made where members of a group use different accounting policies, so that their financial statements are suitable for consolidation.

2.8 Date of inclusion/exclusion

IFRS 10 requires the results of subsidiary undertakings to be included in the consolidated financial statements from:

(a) the date of 'acquisition', ie the **date on which the investor obtains control of the investee**, to

(b) the date of 'disposal', ie the **date the investor loses control of the investee**.

Once an investment is no longer a subsidiary, it should be treated as an associate under IAS 28 (if applicable) or as an investment under IAS 39 (see Chapter 11).

2.9 Accounting for subsidiaries, associates and joint ventures in the parent's separate financial statements

A parent company will usually produce its own single company financial statements. In these statements, investments in subsidiaries, associates and joint ventures included in the consolidated financial statements should be *either*:

(a) Accounted for at **cost**, *or*
(b) In accordance with **IFRS 9**

Where subsidiaries are **classified as held for sale** in accordance with IFRS 5 they should be accounted for in accordance with IFRS 5 in the parent's separate financial statements.

2.10 Disclosure

Disclosure is now regulated by a new standard IFRS 12 *Disclosure of interests in other entities* (see Chapter 12).

2.11 Attribution of losses

Under IFRS 10, non-controlling interests can be negative. This is consistent with the idea that non-controlling interests are part of the equity of the group.

2.12 Special purpose entities

These are dealt with here because they are another example of the exercise of power and control.

An entity may be created to accomplish a specific, defined objective. Examples include research and development, or securitisation of financial assets. Such special purpose entities (SPE) may be incorporated or unincorporated. Often there are strict and permanent limits on the decision-making powers of their governing board or other management. They operate on 'autopilot', ie the policy guiding their activities cannot be modified other than perhaps by their sponsor. The sponsor frequently transfers assets to the SPE or performs services for it.

SPEs come under the same rules as other entities, and are within the scope of IFRS 10. **An SPE should be consolidated** when the **substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity**. IFRS 10 defines **power** and **control** (see section 2.2).

2.12.1 Example: SPE

A company, XY, operates a payroll services division for itself and a number of external customers. It decides to transfer the business of the division to a new entity ABC set up by XY. The sales director of ABC owns 100% of the share capital of ABC. The operating and financial policies of ABC will be decided by the board of XY under a signed contract. ABC's profits and losses will flow to XY and ABC has acquired a loan guaranteed by XY.

The directors of XY wish to avoid consolidating the results of ABC as the loan will adversely affect their gearing ratio.

Discuss how the relationship with ABC should be reflected in the financial statements of the XY group.

Solution

Whilst control is presumed to exist when the parent owns more than half of the voting power**, control may exist when a parent owns less than half the voting power but has the power to govern the operating and financial policies of the entity** under a statute or agreement.

Here, on the face of it, ABC does not look like a subsidiary of XY because XY does not own any of the shares (it is 100% owned by ABC's sales director). However, **the board of XY control the operating and financial policies of ABC under a contractual agreement.** Furthermore, XY retain the risks (if ABC makes losses) and benefits (if ABC makes profits) of ABC because profits and losses of ABC revert to XY. Finally, there is one further indication that XY takes on the risks of ABC - XY acts as guarantor to ABC's loan and would become liable for repayment on default of the loan.

Essentially **ABC is a special purpose entity of XY.** Under IFRS 10, **XY should consolidate 100% of ABC's assets and loan liability.** Non-consolidation just to avoid increasing gearing would result in non-compliance with IFRS 10 therefore is not permitted.

2.13 Summary

IFRS 10 covers the basic rules and definitions of the parent-subsidiary relationship. You should learn:

- **Definitions**
- Rules for **exemption** from preparing consolidated financial statements
- **Disclosure requirements**

3 Content of group accounts and group structure

FAST FORWARD

It is important to distinguish between the parent company individual accounts and the group accounts.

3.1 Introduction

The information contained in the individual financial statements of a parent company and each of its subsidiaries does not give a picture of the group's total activities. A **separate set of group statements** can be prepared from the individual ones. Remember that a group has no separate (legal) existence, except for accounting purposes.

Consolidated accounts are one form of group accounts which combines the information contained in the separate accounts of a holding company and its subsidiaries as if they were the accounts of a single entity. 'Group accounts' and 'consolidated accounts' are terms often used synonymously.

In simple terms a set of consolidated accounts is prepared by **adding together** the assets and liabilities of the parent company and each subsidiary. The **whole** of the assets and liabilities of each company are included, even though some subsidiaries may be only partly owned. The 'equity and liabilities' section of the statement of financial position will indicate how much of the net assets are attributable to the group and how much to outside investors in partly owned subsidiaries. These **outside investors** are known as the **non-controlling interest**.

Key term

Non-controlling interest. The equity in a subsidiary not attributable, directly or indirectly, to a parent.
(IFRS 3, IFRS 10)

Non-controlling interest should be presented in the consolidated statement of financial position **within equity, separately from the parent shareholders' equity**.

Most parent companies present their own individual accounts and their group accounts in a single **package**. The package typically comprises the following.

- **Parent company financial statements**, which will include 'investments in subsidiary undertakings' as an asset in the statement of financial position, and income from subsidiaries (dividends) in the statement of profit or loss
- **Consolidated statement of financial position**
- **Consolidated statement of profit or loss and other comprehensive income**
- **Consolidated statement of cash flows**

It may not be necessary to publish all of the parent company's financial statements, depending on local or national regulations.

3.2 Group structure

With the difficulties of definition and disclosure dealt with, let us now look at group structures. The simplest are those in which a parent company has only a **direct interest** in the shares of its subsidiary companies. For example:

P

100% 80% 75% 90%

S_1 S_2 S_3 S_4

S_1 Co is a wholly owned subsidiary of P Co. S_2 Co, S_3 Co and S_4 Co are partly owned subsidiaries; a proportion of the shares in these companies is held by outside investors.

Often a parent will have **indirect holdings** in its subsidiary companies. This can lead to more complex group structures, involving sub-subsidiaries.

P

51%

S

51%

SS

P Co owns 51% of the equity shares in S Co, which is therefore its subsidiary. S Co in its turn owns 51% of the equity shares in SS Co. SS Co is therefore a subsidiary of S Co and consequently a subsidiary of P Co. SS Co would describe S Co as its parent (or holding) company and P Co as its ultimate parent company.

Note that although P Co can control the assets and business of SS Co by virtue of the chain of control, its interest in the assets of SS Co is only 26%. This can be seen by considering a dividend of $100 paid by SS Co: as a 51% shareholder, S Co would receive $51; P Co would have an interest in 51% of this $51 = $26.01.

During the time until your examination you should obtain as many sets of the published accounts of large companies in your country as possible. Examine the accounting policies in relation to subsidiary and associated companies and consider how these policies are shown in the accounting and consolidation treatment. Also, look at all the disclosures made relating to fair values, goodwill etc and match them to the disclosure requirements outlined in this chapter and in subsequent chapters on IFRS 3 and IAS 28.

Alternatively (or additionally) you should attempt to obtain such information from the financial press.

Exam focus point

You will not be tested on complex group structures, your exam will not feature sub-subsidiaries.

4 Group accounts: the related parties issue

FAST FORWARD

Parent companies and subsidiaries are **related parties** as per IAS 24. Bear in mind that this relationship can be exploited.

IAS 24 draws attention to the significance of related party relationships and transactions – that transactions between the parties may not be 'at arm's length' and that users of the accounts must be made aware of this, as it may affect their view of the financial statements.

4.1 Individual company accounts

The relationship between a parent and a subsidiary is the most obvious example of a related party relationship and it offers a number of opportunities for manipulating results. Some of these may be aimed at improving the parent's individual financial statements.

Any of the following could take place:

- The subsidiary sells goods to the parent company at an artificially low price. This increases parent company profit while reducing profit in the subsidiary, thus increasing profit available for distribution to parent company shareholders at the expense of the non-controlling interest.
- The parent sells goods to the subsidiary at an artificially high price. This has the same result as above.
- The subsidiary makes a loan to the parent at an artificially low rate of interest or the parent makes a loan to the subsidiary at an artificially high rate of interest. The loans will be cancelled on consolidation but the interest payments will transfer profits from the subsidiary to the parent.
- The parent can sell an asset to the subsidiary at an amount in excess of its carrying amount. This again serves to transfer profit (and cash) to the parent.

4.2 Consolidated financial statements

The transactions above seek to improve the **individual** parent company accounts at the expense of the individual subsidiary accounts. Dividends are paid to shareholders on the basis of these individual company financial statements, not the consolidated financial statements.

The tightening up of the opportunities for excluding a subsidiary from consolidation under IFRS 10 (and IAS 27 before it) has reduced the opportunities for improving the appearance of the **consolidated** financial statements. In the past, a number of possibilities could be exploited:

- A group could obtain loans via a subsidiary, which was not then consolidated. The loan would not appear in the consolidated statement of financial position and group gearing (% of capital provided by loans) would appear lower than it actually was.
- Sale and leaseback transactions could be carried out in which assets were sold to a non-consolidated subsidiary and leased back under an operating lease. This enabled the asset and its associated borrowings to be removed from the statement of financial position.

4.3 Disposal of subsidiaries

While the situations above are all concerned with improving the appearance of the parent company or group financial statements at the expense of those of the subsidiary, there may be occasions where the **opposite** is the intention.

For instance, when a parent company has decided to dispose of its shares in a poorly-performing subsidiary, it may seek to enhance the results of that subsidiary for the purpose of selling at a profit. In this case, transactions such as those at 4.1 above may be undertaken in the other direction – to transfer profit from the **parent** to the **subsidiary**.

4.4 Effect on trading

Even where no related party transactions have taken place, the parent/subsidiary relationship can still affect how the parties do business. For instance if, prior to acquisition by the parent, the subsidiary had a major customer or supplier who was a competitor of the parent, that trading arrangement can be expected to cease. The subsidiary may itself have been a competitor of the parent, in which case it may now have had to withdraw from certain markets in favour of the parent.

Look out for any of these issues in a consolidated accounts question.

Chapter Roundup

- Many large businesses consist of several companies controlled by one central or administrative company. Together these companies are called a **group**. The controlling company, called the **parent** or **holding company** will own some or all of the shares in the other companies, called **subsidiaries**.
- IFRS 10 requires a parent to present consolidated financial statements.
- It is important to distinguish between the parent company **individual accounts** and the **group accounts.**
- Parent companies and subsidiaries are **related parties** as per IAS 24. Bear in mind that this relationship can be exploited.

Quick Quiz

1 Define a 'subsidiary'.
2 When can control be assumed?
3 What accounting treatment does IFRS 10 require of a parent company?
4 When is a parent exempted from preparing consolidated financial statements?
5 Under what circumstances should subsidiary undertakings be excluded from consolidation?
6 How should an investment in a subsidiary be accounted for in the separate financial statements of the parent?
7 What is a non-controlling interest?

Answers to Quick Quiz

1 An entity that is controlled by another entity.
2 When the investor has rights to variable returns from the investee and is able to affect those returns by its power over the investee.
3 The accounts of parent and subsidiary are combined and presented as a single entity.
4 When the parent is itself a wholly owned subsidiary, or a partially owned subsidiary and the non-controlling interests do not object, when its securities are not publicly traded and when its ultimate or intermediate parent publishes IFRS-compliant financial statements
5 Very rarely, if at all. See section 2.4.
6 (a) At cost, or
(b) In accordance with IFRS 9.
7 The equity in a subsidiary not attributable, directly or indirectly, to a parent.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q26	Introductory	n/a	n/a

22

The consolidated statement of financial position

Topic list	Syllabus reference
1 IFRS 10: Summary of consolidation procedures	D1
2 Non-controlling interests	D1
3 Dividends paid by a subsidiary	D2
4 Goodwill arising on consolidation	B5, D1
5 Non-controlling interest at fair value	D3
6 Intra-group trading	D2
7 Intra-group sales of non-current assets	D2
8 Summary: consolidated statement of financial position	D1 - 2
9 Acquisition of a subsidiary during its accounting period	D1 - 3
10 Fair values in acquisition accounting	D1 - 3

Introduction

This chapter introduces the **basic procedures** required in consolidation and gives a formal step plan for carrying out a statement of financial position consolidation. This step procedure should be useful to you as a starting guide for answering any question, but remember that you cannot rely on it to answer the question for you.

Each question must be approached and **answered on its own merits**. Examiners often put small extra or different problems in because, as they are always reminding students, it is not possible to 'rote-learn' consolidation.

The **method of consolidation** shown here uses schedules for workings (retained earnings, non-controlling interest etc) rather than the ledger accounts used in some other texts. This is because we believe that ledger accounts lead students to 'learn' the consolidation journals without thinking about what they are doing - always a dangerous practice in consolidation questions.

There are plenty of questions in this chapter – work through **all** of them carefully.

Study guide

D1	**Preparation of group consolidated external reports**
(d)	Prepare a consolidated statement of financial position for a simple group dealing with pre and post acquisition profits, non-controlling interests and goodwill
D2	**Business combinations – intra-group adjustments**
(a)	Explain why intra-group transactions should be eliminated on consolidation
(b)	Report the effects of intra-group trading and other transactions including: – Unrealised profits in inventory and non-current assets – Intra-group loans and interest and other intra-group charges – Intra-group dividends
D3	**Business combinations – fair value adjustments**
(a)	Explain why it is necessary for both the consideration paid for a subsidiary and the subsidiary's identifiable assets and liabilities to be accounted for at their fair values when preparing consolidated financial statements
(b)	Prepare consolidated financial statements dealing with fair value adjustments (including their effect on consolidated goodwill) in respect of: – Depreciating and non-depreciating non-current assets – Inventory – Monetary liabilities – Assets and liabilities (including contingencies) not included in the subsidiary's own statement of financial position
B5	**Intangible assets and goodwill**
(d)	Explain the subsequent accounting treatment, including the principle of impairment tests in relation to purchased goodwill

1 IFRS 10: Summary of consolidation procedures

FAST FORWARD

IFRS 10 lays out the basic procedures for preparing consolidated financial statements.

1.1 Basic procedure

The financial statements of a parent and its subsidiaries are **combined on a line-by-line basis** by adding together like items of assets, liabilities, equity, income and expenses.

The following steps are then taken, in order that the consolidated financial statements should **show financial information about the group as if it was a single entity**.

(a) The carrying amount of the parent's **investment in each subsidiary** and the parent's **portion of equity** of each subsidiary are **eliminated or cancelled**

(b) **Non-controlling interests in the net income of consolidated subsidiaries** are adjusted against group income, to arrive at the net income attributable to the owners of the parent

(c) **Non-controlling interests** in the net assets of consolidated subsidiaries should be presented separately in the consolidated statement of financial position

Other matters to be dealt with include the following.

(a) **Goodwill on consolidation** should be dealt with according to IFRS 3

(b) **Dividends paid** by a subsidiary must be accounted for

IFRS 10 states that all intragroup balances and transactions, and the resulting **unrealised profits**, should be **eliminated in full**. **Unrealised losses** resulting from intragroup transactions should also be eliminated *unless* cost can be recovered. This will be explained later in this chapter.

1.2 Cancellation and part cancellation

The preparation of a consolidated statement of financial position, in a very simple form, consists of two procedures.

(a) Take the individual accounts of the parent company and each subsidiary and **cancel out items** which appear as an asset in one company and a liability in another.

(b) Add together all the uncancelled assets and liabilities throughout the group.

Items requiring cancellation may include the following.

(a) The asset **'shares in subsidiary companies'** which appears in the parent company's accounts will be matched with the liability 'share capital' in the subsidiaries' accounts.

(b) There may be **intra-group trading** within the group. For example, S Co may sell goods on credit to P Co. P Co would then be a receivable in the accounts of S Co, while S Co would be a payable in the accounts of P Co.

1.3 Example: cancellation

P Co regularly sells goods to its one subsidiary company, S Co, which it has owned since S Co's incorporation. The statement of financial position of the two companies on 31 December 20X6 are given below.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6

		P Co	*S Co*
		$	$
Assets			
Non-current assets			
Property, plant and equipment		35,000	45,000
Investment in 40,000 $1 shares in S Co at cost		40,000	
		75,000	
Current assets			
Inventories		16,000	12,000
Receivables:	S Co	2,000	–
	Other	6,000	9,000
Cash at bank		1,000	
Total assets		100,000	66,000
Equity and liabilities			
Equity			
40,000 $1 ordinary shares		–	40,000
70,000 $1 ordinary shares		70,000	–
Retained earnings		16,000	19,000
		86,000	59,000
Current liabilities			
Bank overdraft			3,000
Payables:	P Co		2,000
Payables:	Other	14,000	2,000
Total equity and liabilities		100,000	66,000

Required

Prepare the consolidated statement of financial position of P Co at 31 December 20X6.

Solution

The cancelling items are:

(a) P Co's asset 'investment in shares of S Co' ($40,000) cancels with S Co's liability 'share capital' ($40,000);

(b) P Co's asset 'receivables: S Co' ($2,000) cancels with S Co's liability 'payables: P Co' ($2,000).

The remaining assets and liabilities are added together to produce the following consolidated statement of financial position.

P CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X6

Assets	$	$
Non-current assets		
Property, plant and equipment		80,000
Current assets		
Inventories	28,000	
Receivables	15,000	
Cash at bank	1,000	
		44,000
Total assets		124,000
Equity and liabilities		
Equity		
70,000 $1 ordinary shares	70,000	
Retained earnings	35,000	
	105,000	
Current liabilities		
Bank overdraft	3,000	
Payables	16,000	
		19,000
Total equity and liabilities		124,000

Notes:

1 P Co's bank balance is **not netted off** with S Co's bank overdraft. To offset one against the other would be less informative and would conflict with the principle that assets and liabilities should not be netted off.

2 The share capital in the consolidated statement of financial position is the **share capital of the parent company alone**. This must *always* be the case, no matter how complex the consolidation, because the share capital of subsidiary companies must *always* be a wholly cancelling item.

1.4 Part cancellation

An item may appear in the statements of financial position of a parent company and its subsidiary, but not at the same amounts.

(a) The parent company may have acquired **shares in the subsidiary** at a price **greater or less than their par value**. The asset will appear in the parent company's accounts at cost, while the liability will appear in the subsidiary's accounts at par value. This raises the issue of **goodwill**, which is dealt with later in this chapter.

(b) Even if the parent company acquired shares at par value, it **may not** have **acquired all the shares of the subsidiary** (so the subsidiary may be only partly owned). This raises the issue of **non-controlling interests**, which are also dealt with later in this chapter.

(c) The inter-company trading balances may be out of step because of **goods or cash in transit**.

(d) One company may have **issued loan stock** of which a **proportion only** is taken up by the other company.

The following question illustrates the techniques needed to deal with items (c) and (d) above. The procedure is to **cancel as far as possible**. The remaining uncancelled amounts will appear in the consolidated statement of financial position.

(a) **Uncancelled loan stock** will appear as a **liability of the group**.

(b) **Uncancelled balances on intra-group accounts** represent **goods or cash in transit**, which will appear in the consolidated statement of financial position.

Question — Cancellation

The statements of financial position of P Co and of its subsidiary S Co have been made up to 30 June. P Co has owned all the ordinary shares and 40% of the loan stock of S Co since its incorporation.

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	P Co	S Co
	$	$
Assets		
Non-current assets		
Property, plant and equipment	120,000	100,000
Investment in S Co, at cost		
80,000 ordinary shares of $1 each	80,000	
$20,000 of 12% loan stock in S Co	20,000	
	220,000	
Current assets		
Inventories	50,000	60,000
Receivables	40,000	30,000
Current account with S Co	18,000	
Cash	4,000	6,000
	112,000	96,000
Total assets	332,000	196,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each, fully paid	100,000	80,000
Retained earnings	95,000	28,000
	195,000	108,000
Non-current liabilities		
10% loan stock	75,000	
12% loan stock		50,000
Current liabilities		
Payables	47,000	16,000
Taxation	15,000	10,000
Current account with P Co		12,000
	62,000	38,000
Total equity and liabilities	332,000	196,000

The difference on current account arises because of goods in transit.

Required

Prepare the consolidated statement of financial position of P Co.

Answer

P CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	$	$
Assets		
Non-current assets		
Property, plant and equipment (120,000 + 100,000)		220,000
Current assets		
Inventories (50,000 + 60,000)	110,000	
Goods in transit (18,000 – 12,000)	6,000	
Receivables (40,000 + 30,000)	70,000	
Cash (4,000 + 6,000)	10,000	
		196,000
Total assets		416,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each, fully paid (parent)	100,000	
Retained earnings (95,000 + 28,000)	123,000	
		223,000
Non-current liabilities		
10% loan stock	75,000	
12% loan stock (50,000 × 60%)	30,000	
		105,000
Current liabilities		
Payables (47,000 + 16,000)	63,000	
Taxation (15,000 + 10,000)	25,000	
		88,000
Total equity and liabilities		416,000

Note especially how:

(a) The uncancelled loan stock in S Co becomes a liability of the group
(b) The goods in transit is the difference between the current accounts ($18,000 – $12,000)
(c) The investment in S Co's shares is cancelled against S Co's share capital

2 Non-controlling interests

FAST FORWARD

In the consolidated statement of financial position it is necessary to distinguish **non-controlling interests** from those net assets attributable to the group and financed by shareholders' equity.

2.1 Introduction

It was mentioned earlier that the total assets and liabilities of subsidiary companies are included in the consolidated statement of financial position, even in the case of subsidiaries which are only partly owned. A proportion of the net assets of such subsidiaries in fact belongs to investors from outside the group (**non-controlling interests**).

IFRS 3 allows two alternative ways of calculating non-controlling interest in the group statement of financial position. Non-controlling interest can be valued at:

(a) Its proportionate share of the fair value of the subsidiary's net assets; or
(b) Full (or fair) value (usually based on the market value of the shares held by the non-controlling interest).

You are required to be able to apply both of these methods for DipIFR. The exam question will tell you which method to use. If you are required to use the 'full (or fair) value' method, then you will be given the share price or told what the fair value of the non-controlling interest is. You will normally be required to use the fair value method.

The following example shows non-controlling interest calculated at its proportionate share of the subsidiary's net assets.

2.2 Example: non-controlling interest

P Co has owned 75% of the share capital of S Co since the date of S Co's incorporation. Their latest statements of financial position are given below.

STATEMENT OF FINANCIAL POSITION

	P Co	S Co
	$	$
Assets		
Non-current assets		
Property, plant and equipment	50,000	35,000
30,000 $1 ordinary shares in S Co at cost	30,000	
	80,000	
Current assets	45,000	35,000
Total assets	125,000	70,000
Equity and liabilities		
Equity		
$1 ordinary shares	80,000	40,000
Retained earnings	25,000	10,000
	105,000	50,000
Current liabilities	20,000	20,000
Total equity and liabilities	125,000	70,000

Required

Prepare the consolidated statement of financial position.

Solution

All of S Co's net assets are consolidated despite the fact that the company is only 75% owned. The amount of net assets attributable to non-controlling interests is calculated as follows.

	$
Non-controlling share of share capital (25% × $40,000)	10,000
Non-controlling share of retained earnings (25% × $10,000)	2,500
	12,500

Of S Co's share capital of $40,000, $10,000 is included in the figure for non-controlling interest, while $30,000 is cancelled with P Co's asset 'investment in S Co'.

The consolidated statement of financial position can now be prepared.

P GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Property, plant and equipment		85,000
Current assets		80,000
Total assets		165,000
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	80,000	
Retained earnings $(25,000 + (75% × $10,000))	32,500	
		112,500
Non-controlling interest		12,500
		125,000
Current liabilities		40,000
Total equity and liabilities		165,000

2.3 Procedure

(a) Aggregate the assets and liabilities in the statement of financial position ie 100% P + 100% S irrespective of how much P actually owns.

This shows the amount of net assets **controlled** by the group.

(b) Share capital is that of the parent only.

(c) Balance of subsidiary's reserves are consolidated (after cancelling any intra-group items).

(d) Calculate the non-controlling interest share of the subsidiary's net assets (share capital plus reserves).

Question — Part cancellation

Set out below are the draft statement of financial position of P Co and its subsidiary S Co. You are required to prepare the consolidated statement of financial position. The non-controlling interest is valued at its proportional share of the fair value of the subsidiary's net assets.

P CO

	$	$
Assets		
Non-current assets		
Property, plant and equipment		31,000
Investment in S Co		
12,000 $1 ordinary shares at cost	12,000	
$8,000 10% loan stock at cost	8,000	
		20,000
		51,000
Current assets		21,000
Total assets		72,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	40,000	
Retained earnings	22,000	
		62,000
Current liabilities		10,000
Total equity and liabilities		72,000

S CO

	$	$
Assets		
Property, plant and equipment		34,000
Current assets		32,000
Total assets		66,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	20,000	
Revaluation surplus	6,000	
Retained earnings	4,000	
		30,000
Non-current liabilities		
10% loan stock		26,000
Current liabilities		10,000
Total equity and liabilities		66,000

Answer

The group structure is:

$$\text{P Co} \xrightarrow{60\%} \text{S Co}$$

Partly cancelling items are the components of P Co's investment in S Co, ie ordinary shares, loan stock. Non-controlling shareholders have an interest in 40% (8,000/20,000) of S Co's ordinary shares, including reserves.

You should now aggregate the assets and liabilities and produce workings for non-controlling interest, revaluation surplus and retained earnings as follows.

Workings

(1) *Non-controlling interest*

	$
S Co's net assets (66,000 – 36,000)	30,000
× 40%	12,000

(2) *Revaluation surplus*

	$
P Co	–
Share of S Co's revaluation surplus (60% × 6,000)	3,600
	3,600

(3) *Retained earnings*

	$
P Co	22,000
Share of S Co's retained earnings (60% × 4,000)	2,400
	24,400

The results of the workings are now used to construct the consolidated statement of financial position.

P GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Property, plant and equipment		65,000
Current assets		53,000
Total assets		118,000
Equity and liabilities		
Equity attributable to owners of the parent		
Ordinary shares of $1 each	40,000	
Revaluation surplus (W2)	3,600	
Retained earnings (W3)	24,400	
		68,000
Non-controlling interest (W1)		12,000
		80,000
Non-current liabilities		
10% loan stock (26,000 – 8,000)		18,000
Current liabilities		20,000
Total equity and liabilities		118,000

Notes:

(a) S Co is a subsidiary of P Co because P Co owns 60% of its ordinary capital.

(b) As always, the share capital in the consolidated statement of financial position is that of the parent company alone. The share capital in S Co's statement of financial position was partly cancelled against the investment shown in P Co's statement of financial position, while the uncancelled portion was credited to non-controlling interest.

(c) The figure for non-controlling interest comprises the interest of outside investors in the share capital and reserves of the subsidiary. The uncancelled portion of S Co's loan stock is not shown as part of non-controlling interest but is disclosed separately as a liability of the group.

3 Dividends paid by a subsidiary

When a subsidiary company pays a **dividend** during the year the accounting treatment is not difficult. Suppose S Co, a 60% subsidiary of P Co, pays a dividend of $1,000 on the last day of its accounting period. Its total reserves before paying the dividend stood at $5,000.

(a) $400 of the dividend is paid to non-controlling shareholders. The cash leaves the group and will not appear anywhere in the consolidated statement of financial position.

(b) The parent company receives $600 of the dividend, debiting cash and crediting profit or loss. This will be cancelled on consolidation.

(c) The remaining balance of retained earnings in S Co's statement of financial position ($4,000) will be consolidated in the normal way. The group's share (60% × $4,000 = $2,400) will be included in group retained earnings in the statement of financial position; the non-controlling interest share (40% × $4,000 = $1,600) is credited to the non-controlling interest account in the statement of financial position.

4 Goodwill arising on consolidation

FAST FORWARD

Goodwill is the excess of the amount transferred plus the amount of non-controlling interests over the fair value of the net assets of the subsidiary.

4.1 Accounting

To begin with, **we will examine the entries made by the parent company in its own statement of financial position when it acquires shares.**

When a company P Co wishes to **purchase shares** in a company S Co it must pay the previous owners of those shares. The most obvious form of payment would be in **cash**. Suppose P Co purchases all 40,000 $1 shares in S Co and pays $60,000 cash to the previous shareholders in consideration. The entries in P Co's books would be:

DEBIT	Investment in S Co at cost	$60,000	
CREDIT	Bank		$60,000

However, the previous shareholders might be prepared to accept some other form of consideration. For example, they might accept an agreed number of **shares** in P Co. P Co would then issue new shares in the agreed number and allot them to the former shareholders of S Co. This kind of deal might be attractive to P Co since it avoids the need for a heavy cash outlay. The former shareholders of S Co would retain an indirect interest in that company's profitability via their new holding in its parent company.

Continuing the example, suppose that instead of $60,000 cash the shareholders of S Co agreed to accept one $1 ordinary share in P Co for every two $1 ordinary shares in S Co. P Co would then need to issue and allot 20,000 new $1 shares. How would this transaction be recorded in the books of P Co?

The former shareholders of S Co have presumably agreed to accept 20,000 shares in P Co because they consider each of those shares to have a value of $3. This gives us the following method of recording the transaction in P Co's books.

DEBIT	Investment in S Co	$60,000	
CREDIT	Share capital		$20,000
	Share premium account		$40,000

The amount which P Co records in its books as the cost of its investment in S Co may be more or less than the book value of the assets it acquires. Suppose that S Co in the previous example has nil reserves and nil liabilities, so that its share capital of $40,000 is balanced by tangible assets with a book value of $40,000. For simplicity, assume that the book value of S Co's assets is the same as their market or fair value.

Now when the directors of P Co agree to pay $60,000 for a 100% investment in S Co they must believe that, in addition to its tangible assets of $40,000, S Co must also have intangible assets worth $20,000. This amount of $20,000 paid over and above the value of the tangible assets acquired is called **goodwill arising on consolidation** (sometimes **premium on acquisition**).

Following the normal cancellation procedure the $40,000 share capital in S Co's statement of financial position could be cancelled against $40,000 of the 'investment in S Co' in the statement of financial position of P Co. This would leave a $20,000 debit uncancelled in the parent company's accounts and this $20,000 would appear in the consolidated statement of financial position under the caption 'Intangible non-current assets: goodwill arising on consolidation'.

4.2 Goodwill and pre-acquisition profits

Up to now we have assumed that S Co had nil retained earnings when its shares were purchased by P Co. Assuming instead that S Co had earned profits of $8,000 in the period before acquisition, its statement of financial position just before the purchase would look as follows.

	$
Total assets	48,000
Share capital	40,000
Retained earnings	8,000
	48,000

If P Co now purchases all the shares in S Co it will acquire total assets worth $48,000 at a cost of $60,000. Clearly in this case S Co's intangible assets (goodwill) are being valued at $12,000. It should be apparent that any earnings retained by the subsidiary **prior to its acquisition** by the parent company must be **incorporated in the cancellation** process so as to arrive at a figure for goodwill arising on consolidation. In other words, not only S Co's share capital, but also its **pre-acquisition** retained earnings, must be cancelled against the asset 'investment in S Co' in the accounts of the parent company. The uncancelled balance of $12,000 appears in the consolidated statement of financial position.

The consequence of this is that **any pre-acquisition retained earnings of a subsidiary company are not aggregated with the parent company's retained earnings** in the consolidated statement of financial position. The figure of consolidated retained earnings comprises the retained earnings of the parent company plus the **post-acquisition retained earnings only of subsidiary companies**. The post-acquisition retained earnings are simply retained earnings now *less* retained earnings at acquisition.

The subsidiary may also have share premium or revaluation surplus balances at the acquisition date. These will be brought into the goodwill calculation along with other pre-acquisition reserves. Any post-acquisition movement on these balances will be split between group and NCI.

4.3 Example: goodwill and pre-acquisition profits

Sing Co acquired the ordinary shares of Wing Co on 31 March when the draft statements of financial position of each company were as follows.

SING CO
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	$
Assets	
Non-current assets	
Investment in 50,000 shares of Wing Co at cost	80,000
Current assets	40,000
Total assets	120,000
Equity and liabilities	
Equity	
Ordinary shares	75,000
Retained earnings	45,000
Total equity and liabilities	120,000

WING CO
STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	$
Current assets	60,000
Equity	
50,000 ordinary shares of $1 each	50,000
Retained earnings	10,000
	60,000

Prepare the consolidated statement of financial position as at 31 March.

Solution

The technique to adopt here is to produce a new working: 'Goodwill'. A proforma working is set out below.

Goodwill

	$	$
Consideration transferred		X
Net assets acquired as represented by:		
Ordinary share capital	X	
Share premium	X	
Retained earnings on acquisition	X	
		(X)
Goodwill		X

Applying this to our example the working will look like this.

	$	$
Consideration transferred		80,000
Net assets acquired as represented by:		
Ordinary share capital	50,000	
Retained earnings on acquisition	10,000	
		(60,000)
Goodwill		20,000

SING CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH

	$
Assets	
Non-current assets	
Goodwill arising on consolidation (W)	20,000
Current assets (40,000 + 60,000)	100,000
Total assets	120,000
Equity and liabilities	
Ordinary shares	75,000
Retained earnings	45,000
Total equity and liabilities	120,000

4.4 Goodwill and non-controlling interest

Now let us look at what would happen if Sing Co had obtained less than 100% of the shares of Wing Co.

If Sing Co had paid $70,000 for 40,000 shares in Wing Co, the goodwill working would be as follows:

	$
Consideration transferred	70,000
Non-controlling interest (60,000 × 20%)	12,000
Net assets acquired	(60,000)
Goodwill	22,000

4.5 Non-controlling interest at fair value

IFRS 3 (revised) gives entities the option of valuing non-controlling interest (NCI) at fair value. The thinking behind this is that the non-controlling interest also owns some of the goodwill in the subsidiary, and that the traditional method of consolidation does not show this goodwill.

IFRS 3 revised suggests that the closest approximation to fair value will be the market price of the shares held by non-controlling shareholders just before acquisition by the parent.

Continuing our example above, we will assume that the market price of the shares was $1.25. The goodwill calculation will then be as follows:

	$
Consideration transferred	70,000
Fair value of NCI (10,000 × $1.25)	12,500
Net assets at acquisition	(60,000)
Goodwill	22,500

Goodwill (total $22,500) is $500 higher than goodwill calculated measuring non-controlling interest at its share of the net assets of the subsidiary. This $500 represents the **goodwill attributable to the non-controlling interest**.

4.6 Non-controlling interest at year end

Where the option is used to value non-controlling interest at fair value, the goodwill attributable to the NCI will also be added to the NCI at the year end. The most straightforward way to calculate this is to start with the fair value of the NCI at acquisition and add the NCI share of post-acquisition retained earnings.

This is illustrated in the following worked example.

4.7 Worked example

P acquired 75% of the shares in S on 1 January 2007 when S had retained earnings of $15,000. The market price of S's shares just before the date of acquisition was $1.60. P values non-controlling interest at fair value. Goodwill is not impaired.

The statements of financial position of P and S at 31 December 20X7 were as follows:

	P	S
	$	$
Property, plant and equipment	60,000	50,000
Shares in S	68,000	–
	128,000	50,000
Current assets	52,000	35,000
	180,000	85,000
Share capital – $1 shares	100,000	50,000
Retained earnings	70,000	25,000
	170,000	75,000
Current liabilities	10,000	10,000
	180,000	85,000

Required

Prepare the consolidated statement of financial position of the P Group.

Solution

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$
Assets	
Property plant and equipment (60,000 + 50,000)	110,000
Goodwill (W1)	23,000
Current assets (52,000 + 35,000)	87,000
Total assets	220,000
Equity and liabilities	
Equity attributable to the owners of P	
Share capital	100,000
Retained earnings (W2)	77,500
	177,500
Non-controlling interest (W3)	22,500
Total equity	200,000
Current liabilities (10,000 + 10,000)	20,000
	220,000

Workings

1 *Goodwill*

	Group
	$
Consideration transferred	68,000
Fair value of NCI (12,500 × $1.60)	20,000
Net assets of S at acquisition (50,000 + 15,000)	(65,000)
Goodwill	23,000

2 *Retained earnings*

	P	S
	$	$
Per statement of financial position	70,000	25,000
Less pre- acquisition		(15,000)
		10,000
Group share of S (10,000 × 75%)	7,500	
Group retained earnings	77,500	

3 *Non-controlling interest at year end*

	$
NCI at acquisition	20,000
Share of post-acquisition retained earnings (10,000 × 25%)	2,500
	22,500

4.8 Effect of non-controlling interest at fair value

You can see from the above example that the use of the fair value option increases goodwill and non-controlling interest by the same amount. That amount represents goodwill attributable to the shares held by non-controlling shareholders. It is not necessarily proportionate to the goodwill attributed to the parent. The parent may have paid proportionately more to acquire a controlling interest. If non-controlling interest was valued at share of net assets, goodwill and non-controlling interest in the example above would be as follows:

W1 Goodwill

	$
Considered transferred	68,000
Non-controlling interest ((50,000 + 15,000) × 25%)	16,250
Net assets of S at acquisition (50,000 + 15,000)	(65,000)
	19,250

W3 Non-controlling interest at year end

	$
NCI at acquisition	16,250
Share of post-acquisition retained earnings	2,500
	18,750

Compare these with goodwill and non-controlling interest in the solution above and you will see that both have been reduced by $3,750 – the goodwill attributable to the non-controlling interest. So whether non-controlling interest is valued at share of net assets or at fair value, the statement of financial position will still balance.

Exam focus point

The option to value non-controlling interest at fair value is allowed by the revised IFRS 3, but it is just an **option**. Companies can choose to adopt it or to continue to value non-controlling interest at share of net assets. In the exam you will probably be directed to apply the fair value option. If you are required to use the fair value option, the examiner has stated that there are two possible options:

(1) You may be given the share price of the subsidiary just before acquisition.

(2) You may be told that the non-controlling interest is valued at a certain amount.

In the exam, the consolidation question will tell you which method to use. It will state either:

'It is the group policy to value the non-controlling interest at full (or fair) value;' or

'It is the group policy to value the non-controlling interest at its proportionate share of the (fair value of the) subsidiary's identifiable net assets'.

You are more likely to be tested on non-controlling interest at full (fair) value.

4.9 Impairment of goodwill

Goodwill arising on consolidation is subjected to an annual impairment review and impairment may be expressed as an amount or as a percentage. The double entry to write off the impairment is:

DEBIT Group retained earnings	CREDIT Goodwill

However, when non-controlling interest is valued at **fair value** the goodwill in the statement of financial position includes goodwill attributable to the non-controlling interest. In this case the double entry will reflect the non-controlling interest proportion based on their shareholding as follows:

DEBIT Group retained earnings	CREDIT Goodwill
DEBIT Non-controlling interest	

In our solution above in 4.8 the non-controlling interest holds 25%. If the total goodwill of $23,000 was impaired by 20% the double entry for this would be:

	$		$
DEBIT Retained earnings	3,450	CREDIT Goodwill	4,600
DEBIT Non-controlling interest	1,150		

Non-controlling interest at the year end would then be $21,350.

4.10 Gain on a bargain purchase

Goodwill arising on consolidation is one form of **purchased goodwill**, and is governed by IFRS 3. As explained in an earlier chapter IFRS 3 requires that goodwill arising on consolidation should **be capitalised in the consolidated statement of financial position** and **reviewed for impairment every year**.

Goodwill arising on consolidation is the difference between the cost of an acquisition and the value of the subsidiary's net assets acquired. This difference can be **negative**: the aggregate of the fair values of the separable net assets acquired may **exceed** what the parent company paid for them. This is often referred to as **negative** goodwill. IFRS 3 refers to it as a **'gain on a bargain purchase'**. In this situation:

(a) An entity should first **re-assess** the amounts at which it has measured both the cost of the combination and the acquiree's identifiable net assets. This exercise should **identify any errors.**

(b) Any **excess remaining** should be **recognised immediately in profit or loss**.

4.11 Forms of consideration

The consideration paid by the parent for the shares in the subsidiary can take different forms and this will affect the calculation of goodwill. Here are some examples:

4.11.1 Contingent consideration

The parent acquired 60% of the subsidiary's $100m share capital on 1 Jan 20X6 for a cash payment of $150m and a further payment of $50m on 31 March 20X7 if the subsidiary's post acquisition profits have exceeded an agreed figure by that date.

In the financial statements for the year to 31 December 20X6 $50m will be added to the cost of the combination, discounted as appropriate.

IFRS 3 requires the acquisition-date **fair value** of contingent consideration to be recognised as part of the consideration for the acquiree. In an examination question students will be told the acquisition-date fair value or told how to calculate it.

The acquirer may be required to pay contingent consideration in the form of equity or of a debt instrument or cash. A debt instrument should be presented as under IAS 32. Contingent consideration can also be an asset, if the consideration has already been transferred and the acquirer has the right to require the return of some of it, if certain considerations are met.

Note: The previous version of IFRS 3 only required contingent consideration to be recognised if it was **probable** that it would become payable. IFRS 3 (revised) dispenses with this requirement – **all contingent**

consideration is now recognised. It is possible that the fair value of the contingent consideration may change after the acquisition date. If this is due to additional information obtained that affects the position at acquisition date, goodwill should be remeasured. If the change is due to events after the acquisition date (such as a higher earnings target has been met, so more is payable) it should be accounted for under IFRS 9 if the consideration is in the form of a financial instrument (such as loan notes) or under IAS 37 as an increase in a provision if it is cash. Any equity instrument is not remeasured.

If the contingent consideration consists of an agreement to issue shares at a point in the future, this should be recognised as a separate component of equity – 'shares to be issued'.

4.11.2 Deferred consideration

An agreement may be made that part of the consideration for the combination will be paid at a future date. This consideration will therefore be discounted to its present value using the acquiring entity's cost of capital.

Example

The parent acquired 75% of the subsidiary's 80m $1 shares on 1 January 20X6. It paid $3.50 per share and agreed to pay a further $108m on 1 January 20X7.

The parent company's cost of capital is 8%.

In the financial statements for the year to 31 December 20X6 the cost of the combination will be as follows:

	$m
80m shares × 75% × $3.50	210
Deferred consideration:	
$108m × 1/1.08	100
Total consideration	310

At 31 December 20X6 $8m will be charged to finance costs, being the **unwinding of the discount** on the deferred consideration. The deferred consideration was discounted by $8m to allow for the time value of money. At 1 January 20X7 the full amount becomes payable.

4.11.3 Share exchange

The parent has acquired 12,000 $1 shares in the subsidiary by issuing 5 of its own $1 shares for every 4 shares in the subsidiary. The market value of the parent company's shares is $6.

Cost of the combination:

	$
12,000 × 5/4 × $6	90,000

Note that this is credited to the share capital and share premium of the parent company as follows:

	DR	*CR*
Investment in subsidiary	90,000	
Share capital ($12,000 × 5/4)		15,000
Share premium ($12,000 × 5/4 × 5)		75,000

4.11.4 Expenses and issue costs

Expenses of the combination, such as lawyers and accountants fees are written off as incurred. However, IFRS 3 requires that the costs of issuing equity are treated as a deduction from the proceeds of the equity issue. Share issue costs will therefore be debited to the share premium account. Issue costs of financial instruments are deducted from the proceeds of the financial instrument.

4.12 Consolidation adjustments

At the date of acquisition the parent recognises the assets, liabilities and contingent liabilities of the subsidiary at their fair value at the date when control is acquired. It may be that some of these assets or liabilities had not previously been recognised by the acquiree.

For instance, the subsidiary may have tax losses brought forward, but had not recognised these as an asset because it could not foresee future profits against which they could be offset. If the tax losses can now be utilised by the acquirer they will be recognised as an identifiable asset and included in the goodwill calculation.

5 Non-controlling interest at fair value

Now we will look at a full consolidation question including non-controlling interest at fair value.

Question — **Consolidated statement of financial position**

The draft statements of financial position of Ping Co and Pong Co on 30 June 20X8 were as follows.

STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

	PING CO $	PONG CO $
Assets		
Non-current assets		
Property, plant and equipment	50,000	40,000
20,000 ordinary shares in Pong Co at cost	30,000	
	80,000	
Current assets		
Inventory	3,000	8,000
Owed by Ping Co		10,000
Receivables	16,000	7,000
Cash	2,000	–
	21,000	25,000
Total assets	101,000	65,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	45,000	25,000
Revaluation surplus	12,000	5,000
Retained earnings	26,000	28,000
	83,000	58,000
Current liabilities		
Owed to Pong Co	8,000	–
Trade payables	10,000	7,000
	18,000	7,000
Total equity and liabilities	101,000	65,000

Ping Co acquired its investment in Pong Co on 1 July 20X7 when the retained earnings of Pong Co stood at $6,000. The agreed consideration was $30,000 cash and a further $10,000 on 1 July 20X9. Ping Co's cost of capital is 7%. Pong Co has an internally-developed brand name – 'Pongo' – which was valued at $5,000 at the date of acquisition. There have been no changes in the share capital or revaluation surplus of Pong Co since that date. At 30 June 20X8 Pong Co had invoiced Ping Co for goods to the value of $2,000 and Ping Co had sent payment in full but this had not been received by Pong Co.

There is no impairment of goodwill. It is group policy to value non-controlling interest at full fair value. At the acquisition date the non-controlling interest was valued at $9,000.

Required

Prepare the consolidated statement of financial position of Ping Co as at 30 June 20X8.

Answer

1 **Calculate goodwill**

Goodwill

		Group
		$
Consideration transferred (W2)		38,734
Fair value of NCI		9,000
Net assets acquired as represented by:		
Ordinary share capital	25,000	
Revaluation surplus on acquisition	5,000	
Retained earnings on acquisition	6,000	
Intangible asset – brand name	5,000	
		(41,000)
Goodwill		6,734

This goodwill must be capitalised in the consolidated statement of financial position.

2 **Consideration transferred**

	$
Cash paid	30,000
Fair value of deferred consideration (10,000 × 1/(1.07^{2}*))	8,734
	38,734

* **Note**. The deferred consideration has been discounted at 7% for two years (1 July 20X7 to 1 July 20X9).

However, at the date of the current financial statements, 30 June 20X8, the discount for one year has unwound. The amount of the discount unwound is

	$
(10,000 × 1/1.07) – 8,734	612

So this amount will be charged to finance costs in the consolidated financial statements and the deferred consideration under liabilities will be shown as $9,346 (8,734 + 612).

3 **Calculate consolidated reserves**

Consolidated revaluation surplus

	$
Ping Co	12,000
Share of Pong Co's post acquisition revaluation surplus	–
	12,000

Consolidated retained earnings

	Ping	*Pong*
	$	$
Retained earnings per question	26,000	28,000
Less pre-acquisition		(6,000)
Discount unwound – finance costs	(612)	22,000
Share of Pong: 80% × $22,000	17,600	
	42,988	

4 **Calculate non-controlling interest at year end**

	$
Fair value of non-controlling interest	9,000
Share of post-acquisition retained earnings (22,000 × 20%)	4,400
	13,400

5 **Agree current accounts**

Pong Co has cash in transit of $2,000 which should be added to cash and deducted from the amount owed by Ping Co.

Cancel common items: these are the current accounts between the two companies of $8,000 each.

6 **Prepare the consolidated statement of financial position**

PING CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X8

	$	$
Assets		
Non-current assets		
Property, plant and equipment (50,000 + 40,000)		90,000
Intangible assets: Goodwill (W1)		6,734
Brand name (W1)		5,000
Current assets		
Inventories (3,000 + 8,000)	11,000	
Receivables (16,000 + 7,000)	23,000	
Cash (2,000 + 2,000)	4,000	
		38,000
Total assets		139,734
Equity and liabilities		
Equity		
Ordinary shares of $1 each	45,000	
Revaluation surplus (W3)	12,000	
Retained earnings (W3)	42,988	
		99,988
Non-controlling interest (W4)		13,400
		113,388
Current liabilities		
Trade payables (10,000 + 7,000)		17,000
Deferred consideration (W2)		9,346
Total equity and liabilities		139,734

Exam focus point

A question requiring a consolidated statement of financial position if highly likely to come up in the exam. There is also nearly always an adjustment for intra-group trading, which we look at next.

6 Intra-group trading

FAST FORWARD

Intra-group trading can give rise to **unrealised profit** which is eliminated on consolidation.

6.1 Unrealised profit

Any receivable/payable balances outstanding between the companies are cancelled on consolidation. No further problem arises if all such intra-group transactions are **undertaken at cost**, without any mark-up for profit.

However, each company in a group is a separate trading entity and may wish to treat other group companies in the same way as any other customer. In this case, a company (say A Co) may buy goods at one price and sell them at a higher price to another group company (B Co). The accounts of A Co will quite properly include the profit earned on sales to B Co; and similarly B Co's statement of financial position will include inventories at their cost to B Co, ie at the amount at which they were purchased from A Co.

This gives rise to two problems.

(a) Although A Co makes a profit as soon as it sells goods to B Co, the group does not make a sale or achieve a profit until an outside customer buys the goods from B Co.

(b) Any purchases from A Co which remain unsold by B Co at the year end will be included in B Co's inventory. Their value in the statement of financial position will be their cost to B Co, which is not the same as their cost to the group.

The objective of consolidated accounts is to present the financial position of several connected companies as that of a single entity, the group. This means that **in a consolidated statement of financial position the only profits recognised should be those earned by the group** in providing goods or services to outsiders; and similarly, inventory in the consolidated statement of financial position should be valued at cost to the group.

Suppose that a parent company P Co buys goods for $1,600 and sells them to a wholly owned subsidiary S Co for $2,000. The goods are in S Co's inventory at the year end and appear in S Co's statement of financial position at $2,000. In this case, P Co will record a profit of $400 in its individual accounts, but from the group's point of view the figures are:

Cost	$1,600
External sales	nil
Closing inventory at cost	$1,600
Profit/loss	nil

If we add together the figures for retained earnings and inventory in the individual statements of financial position of P Co and S Co the resulting figures for consolidated retained earnings and consolidated inventory will each be overstated by $400. A **consolidation adjustment** is therefore necessary as follows.

DEBIT	Group retained earnings
CREDIT	Group inventory (statement of financial position)

with the amount of **profit unrealised** by the group.

6.2 Non-controlling interests in unrealised intra-group profits

A further problem occurs where a subsidiary company which is **not wholly owned is involved in intra-group trading** within the group. If a subsidiary S Co is 75% owned and sells goods to the parent company for $16,000 cost plus $4,000 profit, ie for $20,000 and if these items are unsold by P Co at the end of the reporting period, the 'unrealised' profit of $4,000 earned by S Co and charged to P Co will be partly owned by the non-controlling interest of S Co.

The correct treatment of these intragroup profits is to remove the whole profit, charging the non-controlling interest with their proportion.

Entries to learn

DEBIT	Group retained earnings
DEBIT	Non-controlling interest
CREDIT	Group inventory (statement of financial position)

6.3 Example: non-controlling interests and intra-group profits

P Co has owned 75% of the shares of S Co since the incorporation of that company. During the year to 31 December 20X2, S Co sold goods costing $16,000 to P Co at a price of $20,000 and these goods were still unsold by P Co at the end of the year.

Draft statements of financial position of each company at 31 December 20X2 were as follows.

	P Co		*S Co*	
Assets	$	$	$	$
Non-current assets				
Property, plant and equipment	125,000		120,000	
Investment: 75,000 shares in S Co at cost	75,000		–	
		200,000		120,000
Current assets				
Inventories	50,000		48,000	
Trade receivables	20,000		16,000	
		70,000		64,000
Total assets		270,000		184,000
Equity and liabilities				
Equity				
Ordinary shares of $1 each fully paid	80,000		100,000	
Retained earnings	150,000		60,000	
		230,000		160,000
Current liabilities		40,000		24,000
Total equity and liabilities		270,000		184,000

Required

Prepare the consolidated statement of financial position of P Co at 31 December 20X2. The fair value of the non-controlling interest at acquisition was $25,000.

Solution

The profit earned by S Co but unrealised by the group is $4,000 of which $3,000 (75%) is attributable to the group and $1,000 (25%) to the non-controlling interest.

	P Co	*S Co*
	$	$
Retained earnings		
Per question	150,000	60,000
Less unrealised profit		(4,000)
		56,000
Share of S Co: $56,000 × 75%	42,000	
	192,000	
Non-controlling interest		
Fair value at acquisition		25,000
Share of post-acquisition retained earnings (56,000 × 25%)		14,000
		39,000

P CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

	$	$
Assets		
Property, plant and equipment		245,000
Current assets		
Inventories $(50,000 + 48,000 – 4,000)	94,000	
Trade receivables	36,000	
		130,000
Total assets		375,000
Equity and liabilities		
Ordinary shares of $1 each	80,000	
Retained earnings	192,000	
		272,000
Non-controlling interest		39,000
		311,000
Current liabilities		64,000
Total equity and liabilities		375,000

Question — Unrealised profit

P Co acquired 80% of the shares in S Co one year ago when the reserves of S Co stood at $10,000. Draft statements of financial position for each company are as follows.

	P Co		*S Co*	
	$	$	$	$
Assets				
Non-current assets				
Property, plant and equipment	80,000			40,000
Investment in S Co at cost	46,000			
		126,000		
Current assets		40,000		30,000
Total assets		166,000		70,000
Equity and liabilities				
Equity				
Ordinary shares of $1 each	100,000		30,000	
Retained earnings	45,000		22,000	
		145,000		52,000
Current liabilities		21,000		18,000
Total equity and liabilities		166,000		70,000

During the year S Co sold goods to P Co for $50,000, the profit to S Co being 20% of selling price. At the end of the reporting period, $15,000 of these goods remained unsold in the inventories of P Co. At the same date, P Co owed S Co $12,000 for goods bought and this debt is included in the trade payables of P Co and the receivables of S Co. Non-controlling interest is valued at full fair value. It was valued at $9,000 at the date of acquisition.

Required

Prepare a draft consolidated statement of financial position for P Co.

Answer

P CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$	$
Assets		
Non-current assets		
Property, plant and equipment (80,000 + 40,000)	120,000	
Goodwill (W1)	15,000	
		135,000
Current assets (W3)		55,000
Total assets		190,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	100,000	
Retained earnings (W2)	52,200	
		152,200
Non-controlling interest (W5)		10,800
Current liabilities (W4)		27,000
Total equity and liabilities		190,000

Workings

1 *Goodwill*

	$	$
Consideration transferred		46,000
Fair value of non-controlling interest		9,000
Net assets acquired as represented by		
Share capital	30,000	
Retained earnings	10,000	
		(40,000)
Goodwill		15,000

2 *Retained earnings*

	P Co $	*S Co* $
Retained earnings per question	45,000	22,000
Unrealised profit: 20% × $15,000		(3,000)
Pre-acquisition		(10,000)
		9,000
Share of S Co 80%	7,200	
	52,200	

3 *Current assets*

	$	$
In P Co's statement of financial position		40,000
In S Co's statement of financial position	30,000	
Less S Co's current account with P Co cancelled	(12,000)	
		18,000
		58,000
Less unrealised profit excluded from inventory valuation		(3,000)
		55,000

4 *Current liabilities*

	$
In P Co's statement of financial position	21,000
Less P Co's current account with S Co cancelled	(12,000)
	9,000
In S Co's statement of financial position	18,000
	27,000

5 *Non-controlling interest*

	$
Fair value at date of acquisition	9,000
Share of post-acquisition retained earnings (9,000 × 20%)	1,800
	10,800

7 Intra-group sales of non-current assets

FAST FORWARD

As well as engaging in trading activities with each other, group companies may on occasion wish to **transfer non-current assets**.

7.1 Accounting treatment

In their individual accounts the companies concerned will treat the transfer just like a sale between unconnected parties: the selling company will record a profit or loss on sale, while the purchasing company will record the asset at the amount paid to acquire it, and will use that amount as the basis for calculating depreciation.

On consolidation, the usual **'group entity' principle applies**. The consolidated statement of financial position must show assets at their cost to the group, and any depreciation charged must be based on that cost. Two consolidation adjustments will usually be needed to achieve this.

(a) An adjustment to alter retained earnings and non-current assets cost so as to remove any element of unrealised profit or loss. This is similar to the adjustment required in respect of unrealised profit in inventory.

(b) An adjustment to alter retained earnings and accumulated depreciation is made so that consolidated depreciation is based on the asset's cost to the group.

In practice, these steps are combined so that the retained earnings of the entity making the unrealised profit are debited with the unrealised profit less the additional depreciation.

The double entry is as follows.

(a) Sale by parent

DEBIT Group retained earnings
CREDIT Non-current assets

with the profit on disposal, less the additional depreciation.

(b) Sale by subsidiary

DEBIT Group retained earnings (P's share of S)
DEBIT Non-controlling interest (NCI's share of S)
CREDIT Non-current assets

with the profit on disposal, less additional depreciation

7.2 Example: intra-group sale of non-current assets

P Co owns 60% of S Co and on 1 January 20X1 S Co sells plant costing \$10,000 to P Co for \$12,500. The companies make up accounts to 31 December 20X1 and the balances on their retained earnings at that date are:

P Co	after charging depreciation of 10% on plant	\$27,000
S Co	including profit on sale of plant	\$18,000

Required

Show the working for consolidated retained earnings.

Solution

Retained earnings

	P Co	*S Co*
	\$	\$
Per question	27,000	18,000
Disposal of plant		
Profit		(2,500)
Depreciation: 10% × \$2,500		250
		15,750
Share of S Co: \$15,750 × 60%	9,450	
	36,450	

Notes

1 The non-controlling interest in the retained earnings of S Co is 40% × \$15,750 = \$6,300.

2 The asset is written down to cost and depreciation on the 'profit' element is removed. The group profit for the year is thus reduced by a net ((\$2,500 – \$250) × 60%) = \$1,350.

8 Summary: consolidated statement of financial position

Purpose	**To show the net assets which P controls and the ownership of those assets.**
Net assets	Always 100% P plus 100% S providing P holds a majority of voting rights.
Share capital	P only.
Reason	Simply reporting to the parent company's shareholders in another form.
Retained earnings	100% P plus group share of post-acquisition retained earnings of S less consolidation adjustments.
Reason	To show the extent to which the group actually owns total assets less liabilities.
Non-controlling interest	Fair value at acquisition plus share of post-acquisition retained profit (loss).
Reason	To show the equity in a subsidiary not attributable to the parent.

9 Acquisition of a subsidiary during its accounting period

FAST FORWARD

When a parent company acquires a subsidiary during its accounting period the only accounting entries made at the time will be those recording the **cost of acquisition in the parent company's books**. At the end of the accounting period the consolidation adjustments will be made.

9.1 Pre-acquisition profits

As we have already seen, at the end of the accounting year it will be necessary to prepare consolidated accounts.

The subsidiary company's accounts to be consolidated will show the subsidiary's profit or loss for the whole year. For consolidation purposes, however, it will be necessary to distinguish between:

(a) Profits earned before acquisition
(b) Profits earned after acquisition

In practice, a subsidiary company's profit may not accrue evenly over the year; for example, the subsidiary might be engaged in a trade, such as toy sales, with marked seasonal fluctuations. Nevertheless, the assumption can be made that **profits accrue evenly** whenever it is impracticable to arrive at an accurate split of pre– and post-acquisition profits.

Once the amount of pre-acquisition profit has been established the appropriate consolidation workings (goodwill, retained earnings) can be produced.

It is worthwhile to summarise what happens on consolidation to the retained earnings figures extracted from a subsidiary's statement of financial position. Suppose the accounts of S Co, a 60% subsidiary of P Co, show retained earnings of $20,000 at the end of the reporting period, of which $14,000 were earned prior to acquisition. The figure of $20,000 will appear in the consolidated statement of financial position as follows.

	$
Non-controlling interests working: their share of post-acquisition retained earnings (40% × 6,000)	2,400
Goodwill working: pre-acquisition retained earnings	14,000
Consolidated retained earnings working: group share of post-acquisition retained earnings (60% * $6,000)	3,600
	20,000

Exam focus point

The examiner has reported that many candidates fail to apportion the results of the subsidiary to include only its post-acquisition results.

Question

Acquisition

Hinge Co acquired 80% of the ordinary shares of Singe Co on 1 April 20X5. On 31 December 20X4 Singe Co's accounts showed a share premium account of $4,000 and retained earnings of $15,000. The statements of financial position of the two companies at 31 December 20X5 are set out below. Neither company has paid any dividends during the year. Non-controlling interest should be valued at full fair value. The market price of the subsidiary's shares was $2.50 prior to acquisition by the parent.

Required

Prepare the consolidated statement of financial position of Hinge Co at 31 December 20X5. There has been no impairment of goodwill.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	HINGE CO $	SINGE CO $
Assets		
Non-current assets		
Property, plant and equipment	32,000	30,000
16,000 ordinary shares of 50c each in Singe Co	50,000	
	82,000	
Current assets	85,000	43,000
Total assets	167,000	73,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	100,000	
Ordinary shares of 50c each		10,000
Share premium account	7,000	4,000
Retained earnings	40,000	39,000
	147,000	53,000
Current liabilities	20,000	20,000
Total equity and liabilities	167,000	73,000

Answer

Singe Co has made a profit of $24,000 ($39,000 – $15,000) for the year. In the absence of any direction to the contrary, this should be assumed to have arisen evenly over the year; $6,000 in the three months to 31 March and $18,000 in the nine months after acquisition. The company's pre-acquisition retained earnings are therefore as follows.

	$
Balance at 31 December 20X4	15,000
Profit for three months to 31 March 20X5	6,000
Pre-acquisition retained earnings	21,000

The balance of $4,000 on share premium account is all pre-acquisition.

The consolidation workings can now be drawn up.

1 *Goodwill*

	$	$
Consideration transferred		50,000
Non-controlling interest ($2.50 × 4,000)		10,000
Net assets acquired		
represented by		
Ordinary share capital	10,000	
Retained earnings (pre-acquisition)	21,000	
Share premium	4,000	
		(35,000)
Goodwill at acquisition		25,000

2 *Retained earnings*

	Hinge Co $	*Singe Co* $
Per question	40,000	39,000
Pre-acquisition (see above)		(21,000)
		18,000
Share of Singe: $18,000 × 80%	14,400	
	54,400	

3 *Non-controlling interest at reporting date*

	$
NCI at acquisition	10,000
Share of post-acquisition retained earnings (18,000 × 20%)	3,600
	13,600

HINGE CO CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$	$
Assets		
Property, plant and equipment		62,000
Goodwill (W1)		25,000
Current assets		128,000
Total assets		215,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	100,000	
Share premium account	7,000	
Retained earnings (W2)	54,400	
		161,400
Non-controlling interest (W3)		13,600
		175,000
Current liabilities		40,000
Total equity and liabilities		215,000

9.2 Example: pre-acquisition losses of a subsidiary

As an illustration of the entries arising when a subsidiary has pre-acquisition *losses*, suppose P Co acquired all 50,000 $1 ordinary shares in S Co for $20,000 on 1 January 20X1 when there was a debit balance of $35,000 on S Co's retained earnings. In the years 20X1 to 20X4 S Co makes profits of $40,000 in total, leaving a credit balance of $5,000 on retained earnings at 31 December 20X4. P Co's retained earnings at the same date are $70,000.

Solution

The consolidation workings would appear as follows.

1 *Goodwill*

	$	$
Consideration transferred		20,000
Net assets acquired		
as represented by		
Ordinary share capital	50,000	
Retained earnings	(35,000)	
		(15,000)
Goodwill		5,000

2 *Retained earnings*

	P Co	*S Co*
	$	$
At the end of the reporting period	70,000	5,000
Pre-acquisition loss	–	35,000
		40,000
S Co – share of post-acquisition retained earnings		
(40,000 × 100%)	40,000	
	110,000	

10 Fair values in acquisition accounting

FAST FORWARD

Fair values are very important in calculating goodwill.

10.1 Goodwill

To understand the importance of fair values in the acquisition of a subsidiary consider again what we mean by goodwill.

Key term

Goodwill. The excess of the fair value of the consideration transferred plus the amount of non-controlling interests over the fair value of the identifiable net assets of the acquiree on the acquisition date. (IFRS 3)

The **statement of financial position of a subsidiary company** at the date it is acquired may not be a guide to the fair value of its net assets. For example, the market value of a freehold building may have risen greatly since it was acquired, but it may appear in the statement of financial position at historical cost less accumulated depreciation.

10.2 What is fair value?

Fair value is defined as follows by IFRS 13 *Fair value measurement*. It is an important definition.

Key term

Fair value. The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

IFRS 13 provides extensive guidance on how the fair value of assets and liabilities should be established.

This standard requires that the following are considered in determining fair value:

(a) The asset or liability being measured

(b) The principal market (ie that where the most activity takes place) or where there is no principal market, the most advantageous market (ie that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability.

(c) The highest and best use of the asset or liability and whether it is used on a standalone basis or in conjunction with other assets or liabilities

(d) Assumptions that market participants would use when pricing the asset or liability.

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that level 1 inputs are used where possible:

Level 1 Quoted prices in active markets for identical assets that the entity can access at the measurement date.

Level 2 Inputs other than quoted prices that are directly or indirectly observable for the asset.

Level 3 Unobservable inputs for the asset.

We will look at the requirements of IFRS 3 regarding fair value in more detail below. First let us look at some practical matters.

10.3 Fair value adjustment calculations

Until now we have calculated goodwill as the difference between the consideration transferred and the **book value** of net assets acquired by the group. If this calculation is to comply with the definition above we must ensure that the book value of the subsidiary's net assets is the same as their **fair value**.

There are two possible ways of achieving this.

(a) The **subsidiary company** might **incorporate any necessary revaluations** in its own books of account. In this case, we can proceed directly to the consolidation, taking asset values and reserves figures straight from the subsidiary company's statement of financial position.

(b) The **revaluations** may be made as a **consolidation adjustment without being incorporated** in the subsidiary company's books. In this case, we must make the necessary adjustments to the subsidiary's statement of financial position as a working. Only then can we proceed to the consolidation.

Note. Remember that when depreciating assets are revalued there may be a corresponding alteration in the amount of depreciation charged and accumulated. There may also be consequences for **deferred tax**, which were discussed in Chapter 12 (section 7) of this Study Text.

10.4 Example: fair value adjustments

P Co acquired 75% of the ordinary shares of S Co on 1 September 20X5. At that date the fair value of S Co's non-current assets was $23,000 greater than their net book value, and the balance of retained earnings was $21,000. The statements of financial position of both companies at 31 August 20X6 are given below. S Co has not incorporated any revaluation in its books of account. Non-controlling interest is valued at full fair value which was deemed to be $18,000 at the acquisition date.

P CO
STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	$	$
Assets		
Non-current assets		
Property, plant and equipment	63,000	
Investment in S Co at cost	51,000	
		114,000
Current assets		82,000
Total assets		196,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	80,000	
Retained earnings	96,000	
		176,000
Current liabilities		20,000
Total equity and liabilities		196,000

S CO
STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	$	$
Assets		
Property, plant and equipment		28,000
Current assets		43,000
Total assets		71,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	20,000	
Retained earnings	41,000	
		61,000
Current liabilities		10,000
Total equity and liabilities		71,000

If S Co had revalued its non-current assets at 1 September 20X5, an addition of $3,000 would have been made to the depreciation charged for 20X5/X6.

Required

Prepare P Co's consolidated statement of financial position as at 31 August 20X6.

Solution

P CO CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 AUGUST 20X6

	$	$
Non-current assets		
Property, plant and equipment (63,000 + 28,000 + 23,000 – 3,000)	111,000	
Goodwill (W1)	5,000	
		116,000
Current assets		125,000
		241,000
Equity and liabilities		
Equity		
Ordinary shares of $1 each	80,000	
Retained earnings (W2)	108,750	
		188,750
Non-controlling interest (W3)		22,250
		211,000
Current liabilities		30,000
		241,000

Workings

1 *Goodwill*

		Group
		$
Consideration transferred		51,000
Fair value of NCI		18,000
Net assets acquired as represented by		
Ordinary share capital	20,000	
Retained earnings	21,000	
Fair value adjustment	23,000	
		(64,000)
Goodwill		5,000

2 *Retained earnings*

	P Co	*S Co*
	$	$
Per question	96,000	41,000
Pre acquisition profits		(21,000)
Depreciation adjustment		(3,000)
Post acquisition S Co		17,000
Group share in S Co		
($17,000 × 75%)	12,750	
Group retained earnings	108,750	

3 *Non-controlling interest at reporting date*

	$
Fair value at acquisition	18,000
Share of post-acquisition retained earnings (17,000 × 25%)	4,250
	22,250

Question

An asset is recorded in S Co's books at its historical cost of $4,000. On 1 January 20X5 P Co bought 80% of S Co's equity. Its directors attributed a fair value of $3,000 to the asset as at that date. It had been depreciated for two years out of an expected life of four years on the straight line basis. There was no expected residual value. On 30 June 20X5 the asset was sold for $2,600. What is the profit or loss on disposal of this asset to be recorded in S Co's accounts and in P Co's consolidated accounts for the year ended 31 December 20X5?

Answer

S Co: Carrying amount at disposal (at historical cost) = $4,000 × 1½/4 = $1,500
∴ Profit on disposal = $1,100 (depreciation charge for the year = $500)

P Co: Carrying amount at disposal (at fair value) = $3,000 × 1½/2 = $2,250
∴ Profit on disposal for consolidation = $350 (depreciation for the year = $750).

The non-controlling interest would be credited with 20% of both the profit on disposal and the depreciation charge as part of the one line entry in the consolidated statement of profit or loss.

10.5 IFRS 3 (revised) and IFRS 13: Fair values

The general rule under the revised IFRS 3 (revised) is that the subsidiary's assets and liabilities **must be measured at fair value** except in **limited, stated cases**. The assets and liabilities must:

(a) Meet the destinations of assets and liabilities in the *Framework*.

(b) Be part of what the acquiree (or its former owners) exchanged in the business combination rather than the result of separate transactions

IFRS 13 *Fair value measurement* provides extensive guidance on how the fair value of assets and liabilities should be established.

This standard requires that the following are considered in determining fair value:

(a) The asset or liability being measured

(b) The principal market (ie that where the most activity takes place) or where there is no principal market, the most advantageous market (ie that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability

(c) The highest and best use of the asset or liability and whether it is used on a standalone basis or in conjunction with other assets or liabilities

(d) Assumptions that market participants would use when pricing the asset or liability.

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value.
It requires that Level 1 inputs are used where possible:

Level 1 Quoted prices in active markets for identical assets that the entity can access at the measurement date.

Level 2 Inputs other than quoted prices that are directly or indirectly observable for the asset.

Level 3 Unobservable inputs for the asset.

10.5.1 Examples of fair value and business combinations

For non-financial assets, fair value is decided based on the highest and best use of the asset as determined by a market participant. The following examples, adapted from the illustrative examples to IFRS 13, demonstrate what is meant by this.

Example: Land

Anscome Co has acquired land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of land is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, Anscome determines that the land currently used as a site for a factory could be developed as a site for residential use (ie for high-rise apartment buildings) because market participants would take into account the potential to develop the site for residential use when pricing the land.

How would the highest and best use of the land be determined?

Solution

The highest and best use of the land would be determined by comparing both of the following:

(a) The value of the land as currently developed for industrial use (ie the land would be used in combination with other assets, such as the factory, or with other assets and liabilities).

(b) The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (ie the land is to be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of those values.

Example: Research and development project

Searcher has a research and development (R & D) project in a business combination. Searcher does not intend to complete the project. If completed, the project would compete with one of its own projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (ie lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology.

If it could purchase the R & D project, Developer Co would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used (ie the asset would be used in combination with other assets or with other assets and liabilities). Developer Co does not have similar technology.

How would the fair value of the project be measured?

Solution

The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R & D would be used with its complementary assets and the associated liabilities and that those assets and liabilities would be available to Developer Co.

10.5.2 Restructuring and future losses

An acquirer **should not recognise liabilities for future losses** or other costs expected to be incurred as a result of the business combination.

IFRS 3 (revised) explains that a plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore, an acquirer **should not recognise a liability for** such **a restructuring plan** as part of allocating the cost of the combination unless the subsidiary was already committed to the plan before the acquisition.

This **prevents creative accounting**. An acquirer cannot set up a provision for restructuring or future losses of a subsidiary and then release this to profit or loss in subsequent periods in order to reduce losses or smooth profits.

10.5.3 Intangible assets

The acquiree may have **intangible assets**, such as development expenditure. These can be recognised separately from goodwill only if they are **identifiable**. An intangible asset is identifiable only if it:

(a) Is **separable**, ie capable of being separated or divided from the entity and sold, transferred, or exchanged, either individually or together with a related contract, asset or liability, or

(b) Arises from **contractual or other legal rights**.

10.5.4 Contingent liabilities

Contingent liabilities of the acquirer are **recognised** if their **fair value can be measured reliably**. A **contingent liability** must be recognised even if the outflow is not probable, provided there is a present obligation.

This is a departure from the normal rules in IAS 37; contingent liabilities are not normally recognised, but only disclosed.

After their initial recognition, the acquirer should measure contingent liabilities that are recognised separately at the higher of:

(a) The amount that would be recognised in accordance with IAS 37

(b) The amount initially recognised

10.5.5 Other exceptions to the recognition or measurement principles

(a) **Deferred tax:** use IAS 12 values.

(b) **Employee benefits:** use IAS 19 values.

(c) **Indemnification assets:** measurement should be consistent with the measurement of the indemnified item, for example an employee benefit or a contingent liability.

(d) **Reacquired rights**: value on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.

(e) **Share-based payment**: use IFRS 2 values.

(f) **Assets held for sale**: use IFRS 5 values.

Question — Fair value

Tyzo Co prepares accounts to 31 December. On 1 September 20X7 Tyzo Co acquired six million $1 shares in Kono Co at $2.00 per share. At that date Kono Co produced the following interim financial statements.

Non-current assets	$'000
Property, plant and equipment (Note 1)	16.0
Current assets	
Inventories (Note 2)	4.0
Receivables	2.9
Cash and cash equivalents	1.2
	8.1
Total assets	24.1
Equity and liabilities	
Equity	
Share capital ($1 shares)	8.0
Reserves	4.4
	12.4
Non-current liabilities	
Long-term loans	4.0
Current liabilities	
Trade payables	3.2
Provision for taxation	0.6
Bank overdraft	3.9
	(7.7
Total equity and liabilities	24.1

Notes

(a) The following information relates to the property, plant and equipment of Kono Co at 1 September 20X7.

	$m
Gross replacement cost	28.4
Net replacement cost	16.6
Economic value	18.0
Net realisable value	8.0

The property, plant and equipment of Kono Co at 1 September 20X7 had a total purchase cost to Kono Co of $27.0 million. They were all being depreciated at 25 per cent per annum pro rata on that cost. This policy is also appropriate for the consolidated financial statements of Tyzo Co. No non-current assets of Kono Co which were included in the interim financial statements drawn up as at 1 September 20X7 were disposed of by Kono Co prior to 31 December 20X7. No non-current asset was fully depreciated by 31 December 20X7.

(b) The inventories of Kono Co which were shown in the interim financial statements are raw materials at cost to Kono Co of $4 million. They would have cost $4.2 million to replace at 1 September 20X7. Of the inventory of Kono Co in hand at 1 September 20X7, goods costing Kono Co $3.0 million were sold for $3.6 million between 1 September 20X7 and 31 December 20X7.

(c) On 1 September 20X7 Tyzo Co took a decision to rationalise the group so as to integrate Kono Co. The costs of the rationalisation were estimated to total $3.0 million and the process was due to start on 1 March 20X8. No provision for these costs has been made in any of the financial statements given above.

(d) It is the group's policy to value the non-controlling interests at its proportionate share of the fair value of the subsidiary's net assets.

Required

Compute the goodwill on consolidation of Kono Co that will be included in the consolidated financial statements of the Tyzo Co group for the year ended 31 December 20X7, explaining your treatment of the items mentioned above. You should refer to the provisions of relevant accounting standards.

Answer

Goodwill on consolidation of Kono Co

	$m	$m
Consideration ($2.00 × 6m)		12.0
Non-controlling interest (13.2m × 25%)		3.3
		15.3
Group share of fair value of net assets acquired		
Share capital	8.0	
Pre-acquisition reserves	4.4	
	$m	$m
Fair value adjustments		
Property, plant and equipment (16.6 – 16.0)	0.6	
Inventories (4.2 – 4.0)	0.2	
		(13.2)
Goodwill		2.1

Notes on treatment

(a) Share capital and pre-acquisition profits represent the book value of the net assets of Kono Co at the date of acquisition. Adjustments are then required to this book value in order to give the fair value of the net assets at the date of acquisition. For short-term monetary items, fair value is their carrying value on acquisition.

(b) IFRS 3 (revised) states that the fair value of property, plant and equipment should be determined by market value or, if information on a market price is not available (as is the case here), then by reference to depreciated replacement cost, reflecting normal business practice. The net replacement cost (ie $16.6m) represents the gross replacement cost less depreciation based on that amount, and so further adjustment for extra depreciation is unnecessary.

(c) IFRS 3 (revised) also states that raw materials should be valued at replacement cost. In this case that amount is $4.2m.

(d) The rationalisation costs cannot be reported in pre-acquisition results under IFRS 3 (revised) as they are not a liability of Kono Co at the acquisition date.

Chapter Roundup

- IFRS 10 lays out the basic procedures for preparing consolidated financial statements.
- In the consolidated statement of financial position it is necessary to distinguish **non-controlling interests** from those net assets attributable to the group and financed by shareholders' equity.
- **Goodwill** is the excess of the amount transferred plus the amount of non-controlling interests over the fair value of the net assets of the subsidiary.
- Intra-group trading can give rise to **unrealised profit** which is eliminated on consolidation.
- As well as engaging in trading activities with each other, group companies may on occasion wish to **transfer non-current assets**.
- When a parent company acquires a subsidiary during its accounting period the only accounting entries made at the time will be those recording the **cost of the acquisition in the parent company's books**. At the end of the accounting period the consolidation adjustments will be made.
- **Fair values** are very important in calculating goodwill.

Quick Quiz

1 Chicken Co owns 80% of Egg Co. Egg Co sells goods to Chicken Co at cost plus 50%. The total invoiced sales to Chicken Co by Egg Co in the year ended 31 December 20X9 were $900,000 and, of these sales, goods which had been invoiced at $60,000 were held in inventory by Chicken Co at 31 December 20X9. What is the reduction in aggregate group gross profit?

2 Major Co, which makes up its accounts to 31 December, has an 80% owned subsidiary Minor Co. Minor Co sells goods to Major Co at a mark-up on cost of 33.33%. At 31 December 20X8, Major had $12,000 of such goods in its inventory and at 31 December 20X9 had $15,000 of such goods in its inventory.

What is the amount by which the consolidated profit attributable to Major Co's shareholders should be adjusted in respect of the above?

Ignore taxation

A $1,000 Debit
B $800 Credit
C $750 Credit
D $600 Debit

3 Goodwill is always positive. True or false?

4 A parent company can assume that, for a subsidiary acquired during its accounting period, profits accrue evenly during the year. True or false?

5 What entries are made in the workings to record the pre-acquisition profits of a subsidiary?

6 Under IFRS 13 *Fair value measurement,* what is meant by Level 1 inputs?

7 Where does unrealised profit on intra-group trading appear in the statement of profit or loss?

Answers to Quick Quiz

1 $\$60,000 \times \frac{50}{150} = \$20,000$

2 D $(15,000 - 12,000) \times \frac{33.3}{133.3} \times 80\%$

3 False. Goodwill can be negative if the purchaser has 'got a bargain'.

4 Not necessarily – the examiner will advise you on this.

5 See Para 4.2

6 Quoted prices in active markets for identical assets that the entity can access at the measurement date.

7 As an addition to cost of sales

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q27	Introductory	n/a	n/a
Q28	Introductory	n/a	n/a

23 The consolidated statement of profit or loss and other comprehensive income

Topic list	Syllabus reference
1 The consolidated statement of profit or loss	D1
2 The consolidated statement of profit or loss and other comprehensive income	D1

Introduction

This chapter deals with the consolidated statement of profit or loss and the consolidated statement of profit or loss and other comprehensive income.

Most of the consolidation adjustments will involve the **statement of profit or loss**, so that is the focus of this chapter.

Study guide

D1	**Preparation of group consolidated external reports**
(f)	Prepare a consolidated statement of profit or loss, statement of statement of profit or loss and other comprehensive income and statement of changes in equity for a simple group, including an example where an acquisition occurs during the year where there is a non-controlling interest

1 The consolidated statement of profit or loss

FAST FORWARD

The source of the consolidated statement of profit or loss is the individual statements of profit or loss of the separate companies in the group.

1.1 Consolidation procedure

It is customary in practice to prepare a working paper (known as a **consolidation schedule**) on which the individual statements of profit or loss are set out side by side and totalled to form the basis of the consolidated statement of profit or loss.

Exam focus point

In an examination it is very much quicker not to do this. Use workings to show the calculation of complex figures such as the non-controlling interest and show the derivation of others on the face of the statement of profit or loss, as shown in our examples.

FAST FORWARD

In the consolidated statement of profit or loss, non-controlling interest is brought in as a one-line adjustment at the end of the statement.

1.2 Simple example: consolidated statement of profit or loss

P Co acquired 75% of the ordinary shares of S Co on that company's incorporation in 20X3. The summarised statements of profit or loss and movement on retained earnings of the two companies for the year ending 31 December 20X6 are set out below.

	P Co	*S Co*
	$	$
Sales revenue	75,000	38,000
Cost of sales	(30,000)	(20,000)
Gross profit	45,000	18,000
Administrative expenses	(14,000)	(8,000)
Profit before tax	31,000	10,000
Income tax expense	(10,000)	(2,000)
Profit for the year	21,000	8,000
Note: Movement on retained earnings		
Retained earnings brought forward	87,000	17,000
Profit for the year	21,000	8,000
Retained earnings carried forward	108,000	25,000

Required

Prepare the consolidated statement of profit or loss and extract from the statement of changes in equity showing retained earnings and non-controlling interest.

Solution

P CO
CONSOLIDATED STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 31 DECEMBER 20X6

	$
Sales revenue (75 + 38)	113,000
Cost of sales (30 + 20)	(50,000)
Gross profit	63,000
Administrative expenses (14 + 8)	(22,000)
Profit before tax	41,000
Income tax expense	(12,000)
Profit for the year	29,000
Profit attributable to:	
Owners of the parent	27,000
Non-controlling interest ($8,000 × 25%)	2,000
	29,000

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	Retained Earnings	*Non-controlling Interest*	*Total Equity*
	$	$	$
Balance at 1 January 20X6	99,750	4,250	104,000
Total comprehensive income for the year	27,000	2,000	29,000
Balance at 31 December 20X6	126,750	6,250	133,000

Notice how the non-controlling interest is dealt with.

(a) Down to the line **'profit for the year'** the **whole** of S Co's results is included without reference to group share or non-controlling share. A **one-line adjustment** is then inserted to deduct the non-controlling share of S Co's profit.

(b) The non-controlling share ($4,250) of S Co's retained earnings brought forward (17,000 × 25%) is **excluded** from group retained earnings. This means that the carried forward figure of $126,750 is the figure which would appear in the statement of financial position for group retained earnings.

This last point may be clearer if we construct the working for group retained earnings.

Group retained earnings

	P Co	*S Co*
	$	$
At year end	108,000	25,000
Less pre-acquisition retained earnings		–
		25,000
S Co – share of post acquisition retained earnings (25,000 × 75%)	18,750	
	126,750	

The non-controlling share of S Co's retained earnings comprises the non-controlling interest in the $17,000 profits brought forward plus the non-controlling interest ($2,000) in $8,000 retained profits for the year.

We will now look at the complications introduced by **intra-group trading**, **intra-group dividends** and **pre-acquisition profits** in the subsidiary.

1.3 Intra-group trading

FAST FORWARD

Intra-group sales and purchases are eliminated from the consolidated statement of profit or loss.

Like the consolidated statement of financial position, the consolidated statement of profit or loss should deal with the results of the group as those of a single entity. When one company in a group sells goods to

another the relevant amount is added to the sales revenue of the first company and to the cost of sales of the second. Yet as far as the entity's dealings with outsiders are concerned no sale has taken place.

The consolidated figures for sales revenue and cost of sales should represent **sales to**, and **purchases from, outsiders**. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figures by the value of intra-group sales during the year.

We have also seen in an earlier chapter that any unrealised profits on intra-group trading should be excluded from the figure for group profits. This will occur whenever goods sold at a profit within the group remain in the inventory of the purchasing company at the year end. The best way to deal with this is to **calculate the unrealised profit on unsold inventories at the year end and reduce consolidated gross profit by this amount**. Cost of sales will be the balancing figure.

1.4 Example: intra-group trading

Suppose in our earlier example that S Co had recorded sales of $5,000 to P Co during 20X6. S Co had purchased these goods from outside suppliers at a cost of $3,000. One half of the goods remained in P Co's inventory at 31 December 20X6.

Prepare the revised consolidated statement of profit or loss.

Solution

The consolidated statement of profit or loss for the year ended 31 December 20X6 would now be as follows.

	$
Sales revenue (75 + 38 – 5)	108,000
Cost of sales (30 + 20 – 5 + 1*)	(46,000)
Gross profit (45 + 18 – 1*)	62,000
Administrative expenses	(22,000)
Profit before taxation	40,000
Income tax expense	(12,000)
Profit for the year	28,000
Profit attributable to :	
Owners of the parent	26,250
Non-controlling interest (8,000 – 1,000) × 25%	1,750
	28,000

Note:

Retained earnings brought forward	99,750
Profit for the year	26,250
Retained earnings carried forward	126,000

*Unrealised profit: ½ × ($5,000 – $3,000)

An adjustment will be made for the unrealised profit against the inventory figure in the consolidated statement of financial position.

1.5 Intra-group dividends

In our example so far we have assumed that S Co retains all of its after-tax profit. It may be, however, that S Co distributes some of its profits as dividends. As before, the **non-controlling interest** in the subsidiary's profit should be calculated immediately after the figure of after-tax profit. For this purpose, no account need be taken of how much of the non-controlling interest is to be distributed by S Co as dividend.

Note that group retained earnings are only adjusted for dividends paid to the parent company shareholders. Dividends paid by the subsidiary to the parent are cancelled on consolidation and dividends paid to the non-controlling interest are replaced by the allocation to the non-controlling interest of their share of the profit for the year of the subsidiary.

1.6 Pre-acquisition profits

FAST FORWARD

Only the **post-acquisition** profits of the subsidiary are brought into the consolidated profit or loss.

As explained above, the figure for retained earnings carried forward must be the same as the figure for retained earnings in the consolidated statement of financial position. We have seen in previous chapters that retained earnings in the consolidated statement of financial position comprise:

(a) The **whole of the parent company's** retained earnings

(b) A **proportion of the subsidiary company's** retained earnings. The proportion is the **group's share of post-acquisition retained earnings** in the subsidiary. From the total retained earnings of the subsidiary we must therefore **exclude** both the **non-controlling share** of total retained earnings and the **group's share of pre-acquisition** retained earnings.

A **similar procedure is necessary in the consolidated statement of profit or loss** if it is to link up with the consolidated statement of financial position. Previous examples have shown how the non-controlling share of profits is treated in the statement of profit or loss. Their share of profits for the year is deducted from profit after tax, while the figure for profits brought forward in the consolidation schedule includes only the group share of the subsidiary's profits.

In the same way, when considering examples which include pre-acquisition profits in a subsidiary, the figure for profits brought forward should include only the group share of the post-acquisition retained profits. If the subsidiary is **acquired during the accounting year**, it is therefore necessary to apportion its profit for the year between pre-acquisition and post-acquisition elements. The part-year method is used.

With the part-year method, the entire statement of profit or loss of the subsidiary is split between pre-acquisition and post-acquisition amounts. Only the post-acquisition figures are included in the consolidated statement of profit or loss.

Question — Acquisition

P Co acquired 60% of the $100,000 equity of S Co on 1 April 20X5. The statements of profit or loss of the two companies for the year ended 31 December 20X5 are set out below.

	P Co	*S Co*	*S Co* ($^9/_{12}$)
	$	$	$
Sales revenue	170,000	80,000	60,000
Cost of sales	(65,000)	(36,000)	(27,000)
Gross profit	105,000	44,000	33,000
Other income – dividend received S Co	3,600		
Administrative expenses	(43,000)	(12,000)	(9,000)
Profit before tax	65,600	32,000	24,000
Income tax expense	(23,000)	(8,000)	(6,000)
Profit for the year	42,600	24,000	18,000

Note

Dividends (paid 31 December)	12,000	6,000
Profit retained	30,600	18,000
Retained earnings brought forward	81,000	40,000
Retained earnings carried forward	111,600	58,000

Required

Prepare the consolidated statement of profit or loss and the retained earnings and non-controlling interest extracts from the statement of changes in equity.

Answer

The shares in S Co were acquired three months into the year. Only the post-acquisition proportion (9/12ths) of S Co's statement of profit or loss is included in the consolidated statement of profit or loss. This is shown above for convenience.

P CO CONSOLIDATED STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 31 DECEMBER 20X5

	$
Sales revenue (170 + 60)	230,000
Cost of sales (65 + 27)	(92,000)
Gross profit	138,000
Administrative expenses (43 + 9)	(52,000)
Profit before tax	86,000
Income tax expense (23 + 6)	(29,000)
Profit for the year	57,000
Profit attributable to:	
Owners of the parent	49,800
Non-controlling interest (18 × 40%)	7,200
	57,000

STATEMENT OF CHANGES IN EQUITY

	Retained earnings	*Non-controlling interest*
	$	$
Balance at 1 January 20X5	81,000	–
Dividends paid (6,000 – 3,600)	(12,000)	(2,400)
Total comprehensive income for the year	49,800	7,200
Added on acquisition of subsidiary (W)	–	58,400
Balance at 31 December 20X5	118,800	63,200

Note: All of S Co's profits brought forward are pre-acquisition.

Working

	$
Added on acquisition of subsidiary:	
Share capital	100,000
Retained earnings brought forward	40,000
Profits Jan-March 20X5 (24,000 – 18,000)	6,000
	146,000
Non-controlling share 40%	58,400

Question

Non-controlling interest

The following information relates to Brodick Co and its subsidiary Lamlash Co for the year to 30 April 20X7.

	Brodick Co	*Lamlash Co*
	$'000	$'000
Sales revenue	1,100	500
Cost of sales	(630)	(300)
Gross profit	470	200
Administrative expenses	(105)	(150)
Dividend from Lamlash Co	24	–
Profit before tax	389	50
Income tax expense	(65)	(10)
Profit for the year	324	40

Note

Dividends paid	200	30
Profit retained	124	10
Retained earnings brought forward	460	48
Retained earnings carried forward	584	58

Additional information

(a) The issued share capital of the group was as follows.

Brodick Co: 5,000,000 ordinary shares of $1 each
Lamlash Co: 1,000,000 ordinary shares of $1 each

(b) Brodick Co purchased 80% of the issued share capital of Lamlash Co on 1 November 20X6. At that time, the retained earnings of Lamlash stood at $52,000.

Required

Insofar as the information permits, prepare the Brodick group consolidated statement of profit or loss for the year to 30 April 20X7, and extracts from the statement of changes in equity showing group retained earnings and the non-controlling interest.

Answer

BRODICK GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS
FOR THE YEAR TO 30 APRIL 20X7

	$'000
Sales revenue (1,100 + (500 × 6/12))	1,350
Cost of sales (630 + (300 × 6/12))	(780)
Gross profit	570
Administrative expenses (105 + (150 × 6/12))	(180)
Profit before tax	390
Income tax expense (65 + (10 × 6/12))	(70)
Profit for the year	320
Profit attributable to:	
Owners of the parent	316
Non-controlling interest (W1)	4
	320

STATEMENT OF CHANGES IN EQUITY

	Retained earnings $'000	*Non-controlling interest* $'000
Balance brought forward 1 May 20X6	460	–
Added on acquisition of subsidiary (W2)	–	210
Dividends paid – per Qn/(30,000 – 24,000)	(200)	(6)
Total comprehensive income for the year (W1)	316	4
Balance carried forward 30 April 20X7	576	208

Workings

1 *Non-controlling interests*

	$'000
In Lamlash (20% × 40) × 6/12	4

2 *Added on acquisition of subsidiary*

	$'000
Share capital	1,000
Retained earnings	52
	1,052
Non-controlling share 20%	210

1.7 Section summary

The table below summarises the main points about the consolidated statement of profit or loss.

Purpose	To show the results of the group for an accounting period as if it were a single entity.
Sales revenue to profit for year	100% P + 100% S (excluding adjustments for intra-group transactions).
Reason	To show the results of the group which were controlled by the parent company.
Intra-group sales	Strip out intra-group activity from both sales revenue and cost of sales.
Unrealised profit on intra-group sales	(a) Goods sold by P. Increase cost of sales by unrealised profit. (b) Goods sold by S. Increase cost of sales by full amount of unrealised profit and decrease non-controlling interest by their share of unrealised profit.
Depreciation	If the value of S's non-current assets have been subjected to a fair value uplift then any additional depreciation must be charged to profit or loss. The non-controlling interest will need to be adjusted for their share.
Transfer of non-current assets	Expenses must be increased by any profit on the transfer and reduced by any additional depreciation arising from the increased carrying value of the asset.
Non-controlling interests	S's profit after tax (PAT) X Less: * unrealised profit (X) * profit on disposal of non-current assets (X) additional depreciation following FV uplift (X) Add: ** additional depreciation following disposal of non-current assets X X NCI% X * Only applicable if sales of goods and non-current assets made by subsidiary. ** Only applicable if sale of non-current assets made by subsidiary.
Reason	To show the extent to which profits generated through P's control are in fact owned by other parties.

2 The consolidated statement of profit or loss and other comprehensive income

FAST FORWARD

The consolidated statement of profit or loss and other comprehensive income is produced using the consolidated statement of profit or loss as a basis.

The only items of other comprehensive income that are included in your syllabus are revaluation gains and losses, so a consolidated statement of profit or loss and other comprehensive income will be easy to produce once you have done the consolidated statement of profit or loss.

We will take the last question and add an item of comprehensive income to illustrate this.

2.1 Example: Comprehensive income

The consolidated statement of profit or loss of the Brodrick Group is as in the answer to the last question. In addition, Lamlash made a $200,000 revaluation gain on one of its properties during the year.

2.2 Solution

BRODRICK GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR TO 30 APRIL 20X7

	$'000
Sales revenue	1,600
Cost of sales	(930)
Gross profit	670
Administrative expenses	(255)
Profit before tax	415
Income tax expense	(75)
Profit for the year	340
Other comprehensive income (not re-classified to P/L)	
Gain on property revaluation	200
Total comprehensive income for the year	540
Profit attributable to:	
Owners of the parent	332
Non-controlling interest	8
	340
Total comprehensive income attributable to:	
Owners of the parent (332 + (200 × 80%))	492
Non-controlling interest (8 + (200 × 20%))	48
	540

2.3 Consolidated statement of profit or loss and other comprehensive income (separate statement)

If we were using the two-statement format (as explained in Chapter 3) we would produce a separate statement of profit or loss and statement of other comprehensive income.

2.4 Example: Other comprehensive income

BRODRICK GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Profit for the year	340
Other comprehensive income:	
Gain on property revaluation	200
Total comprehensive income for the year	540
Total comprehensive income attributable to:	
Owners of the parent (332 + (200 × 80%))	492
Non-controlling interest (8 + (200 × 20%)	48
	540

2.5 Full worked example

On 1 July 20X8 Crystal acquired 60,000 of the 100,000 shares in Pebble, its only subsidiary. The draft statements of profit or loss and other comprehensive income of both companies at 31 December 20X8 are shown below:

	Crystal	Pebble
	$'000	$'000
Revenue	43,000	26,000
Cost of sales	(28,000)	(18,000)
Gross profit	15,000	8,000
Other income – dividend received from Pebble	2,000	-
Distribution costs	(2,000)	(800)
Administrative expenses	(4,000)	(2,200)
Finance costs	(500)	(300)
Profit before tax	10,500	4,700
Income tax expense	(1,400)	(900)
Profit for the year	9,100	3,800
Other comprehensive income:		
Gain on property revaluation (Note (i))	-	2,000
Investment in equity instrument	200	-
Total comprehensive income for the year	9,300	5,800

Additional information:

(i) At the date of acquisition the fair values of Pebble's assets were equal to their carrying amounts with the exception of a building which had a fair value $1million in excess of its carrying amount. At the date of acquisition the building had a remaining useful life of 20 years. Building depreciation is charged to administrative expenses. The building was revalued again at 31 December 20X8 and its fair value had increased by an additional $1million.

(ii) Sales from Crystal to Pebble were $6million during the post-acquisition period. Crystal marks up all sales by 20%.

(iii) Despite the property revaluation, Crystal has concluded that goodwill in Pebble has been impaired by $500,000.

(iv) It is Crystal's policy to value the non-controlling interest at full (fair) value.

(v) Income and expenses can be assumed to have arisen evenly throughout the year.

Prepare the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8.

Solution

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	$'000
Revenue (43,000 + (26,000 × 6/12) – 6,000 (W1))	50,000
Cost of sales (28,000 + (18,000 × 6/12) – 6,000 + 1,000 (W1))	(32,000)
Gross profit	18,000
Distribution costs (2,000 + (800 × 6/12))	(2,400)
Administrative expenses (4,000 + (2,200 × 6/12) + 25 (W2) + 500 impairment)	(5,625)
Finance costs (500 + (300 × 6/12))	(650)
Profit before tax	9,325
Income tax expense (1,400 + (900 × 6/12))	(1,850)
Profit for the year	7,475
Other comprehensive income (not re-classified to P/L)	
Gain on property revaluation(post-acquisition)	1,000
Investment in equity instrument	200
Total comprehensive income for the year	8,675
Profit attributable to:	
Owners of the parent	6,925
Non-controlling interest (W3)	550
	7,475
Total comprehensive income attributable to:	
Owners of the parent	7,725
Non-controlling interest (550 + (1,000 × 40%)	950
	8,675

Workings

1 Unrealised profit

Remove intercompany trading:

DR Revenue $6m / CR Cost of sales $6m

Unrealised profit = 6,000 × 20/120 = 1,000 – add to cost of sales

2 Movement on fair value adjustment

The fair value adjustment of $1m will be depreciated over the remaining life of the building. The amount to be charged at 31 December is:

1,000,000/20 × 6/12 = 25,000

40% of this (10,000) will be charged to the NCI.

3 Non-controlling interest – share of profit for the year

	$'000
Share of post-acquisition profit (3,800 × 6/12 × 40%)	760
Movement on fair value adjustment (25 × 40%)	(10)
Share of goodwill impairment (500 × 40%)	(200)
	550

Chapter Roundup

- The source of the consolidated statement of profit or loss is the individual statements of profit or loss of the separate companies in the group.
- In the consolidated statement of profit or loss non-controlling interest is brought in as a one-line adjustment at the end of the statement.
- Intra-group sales and purchases are eliminated from the consolidated statement of profit or loss.
- Only the **post-acquisition** profits of the subsidiary are brought into the consolidated profit or loss.
- The consolidated statement of profit or loss and other comprehensive income is produced using the consolidated statement of profit or loss as a basis.

Quick Quiz

1 Where does unrealised profit on intra-group trading appear in the statement of profit or loss?

2 At the beginning of the year a 75% subsidiary transfers a non-current asset to the parent for \$500,000. It's carrying value was \$400,000 and it has 4 years of useful life left. How is this accounted for at the end of the year in the consolidated statement of profit or loss?

Answers to Quick Quiz

1 As a deduction from consolidated gross profit.

2

	\$
Unrealised profit	100,000
Additional depreciation (100 ÷ 4)	(25,000)
Net charge to profit or loss	75,000

	DR	CR
	\$	\$
Non-current asset		100,000
Additional depreciation	25,000	
Group profit (75%)	56,250	
Non-controlling interest (25%)	18,750	
	100,000	100,000

Now try the questions below from the Practice Question Bank

Number	Level	Marks	Time
Q29	Examination	20	36 mins
Q30	Introductory	20	36 mins
Q31	Introductory	15	27 mins

24

Accounting for associates

Topic list	Syllabus reference
1 Accounting for associates	D4
2 The equity method	D4
3 Statement of profit or loss and statement of financial position	D4

Introduction

In this chapter we deal with the treatment of associates in the consolidated financial statements. As the group's share of profit in the associate appears under profit or loss rather than other comprehensive income, we have concentrated on the separate statement of profit or loss.

Study guide

D4	**Business combinations – associates and joint ventures**
(a)	Define associates and joint ventures (ie jointly controlled operations, assets and entities)
(b)	Prepare consolidated financial statements to include a single subsidiary and an associated company or a joint venture

1 Accounting for associates

FAST FORWARD

This is covered by IAS 28 *Investments in associates*. The investing company does not have control, as it does with a subsidiary, but it does have **significant influence**.

1.1 Definitions

We looked at some of the important definitions in Chapter 21; these are repeated here with some additional important terms.

Key terms

- **Associate**. An entity, including an unincorporated entity such as a partnership, over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture.
- **Significant influence** is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.
- **Equity method**. A method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee. The profit or loss of the investor includes the investor's share of the profit or loss of the investee.

We have already looked at how the **status** of an investment in an associate should be determined. Go back to Section 1 of Chapter 21 to revise it. (**Note**. As for an investment in a subsidiary, any **potential voting rights** should be taken into account in assessing whether the investor has **significant influence** over the investee.)

IAS 28 requires all investments in associates to be accounted for in the consolidated accounts using the equity method, *unless* the investment is classified as 'held for sale' in accordance with IFRS 5 in which case it should be accounted for under IFRS 5 (see Chapter 17), or the exemption in the paragraph below applies.

An investor is exempt from applying the equity method if:

(a) It is a parent exempt from preparing consolidated financial statements under IFRS 10, or

(b) All of the following apply:

    (i) The investor is a **wholly-owned subsidiary** or it is a **partially owned subsidiary** of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the investor not applying the equity method;
    (ii) The investor's securities are **not publicly traded**
    (iii) It is **not in the process of issuing securities** in public securities markets; and
    (iv) The **ultimate or intermediate parent** publishes consolidated financial statements that comply with International Financial Reporting Standards.

The revised version of IAS 28 **no longer allows** an investment in an associate to be excluded from equity accounting when an investee operates under severe long-term restrictions that significantly impair its ability to transfer funds to the investor. Significant influence must be lost before the equity method ceases to be applicable.

The use of the equity method should be **discontinued** from the date that the investor **ceases to have significant influence.**

From that date, the investor shall account for the investment in accordance with IFRS 9 *Financial instruments*. The carrying amount of the investment at the date that it ceases to be an associate shall be regarded as its cost on initial measurement as a financial asset under IFRS 9.

1.2 Separate financial statements of the investor

If an investor **issues consolidated financial statements** (because it has subsidiaries), an investment in an associate should be *either*:

(a) Accounted for at **cost**, or
(b) In accordance with **IFRS 9** (at fair value)

in its separate financial statements.

If an investor that does ***not*** **issue consolidated financial statements** (ie it has no subsidiaries) but has an investment in an associate this should similarly be included in the financial statements of the investor either at cost, or in accordance with IFRS 9 (see Chapter 11).

2 The equity method

2.1 Application of the equity method: consolidated accounts

Many of the procedures required to apply the equity method are the same as are required for full consolidation. In particular, **intra-group unrealised profits** must be excluded.

2.1.1 Consolidated statement of profit or loss

The basic principle is that the investing company (X Co) should take account of its **share of the earnings** of the associate, Y Co, whether or not Y Co distributes the earnings as dividends. X Co achieves this by adding to consolidated profit the group's share of Y Co's profit after tax.

Notice the difference between this treatment and the **consolidation** of a subsidiary company's results. If Y Co were a subsidiary X Co would take credit for the whole of its sales revenue, cost of sales etc and would then make a one-line adjustment to remove any non-controlling share.

Under equity accounting, the associate's sales revenue, cost of sales and so on are ***not*** **amalgamated** with those of the group. Instead the group share only of the associate's profit after tax for the year is added to the group profit.

2.1.2 Consolidated statement of financial position

A figure for **investment in associates** is shown which at the time of the acquisition must be stated at cost. At the end of each accounting period the group share of the retained reserves of the associate is added to the original cost to get the total investment to be shown in the consolidated statement of financial position.

2.2 Example: associate

P Co, a company with subsidiaries, acquires 25,000 of the 100,000 $1 ordinary shares in A Co for $60,000 on 1 January 20X8. In the year to 31 December 20X8, A Co earns profits after tax of $24,000, from which it pays a dividend of $6,000.

How will A Co's results be accounted for in the individual and consolidated accounts of P Co for the year ended 31 December 20X8?

Solution

In the **individual accounts** of P Co, the investment will be recorded on 1 January 20X8 at cost. Unless there is an impairment in the value of the investment (see below), this amount will remain in the individual statement of financial position of P Co permanently. The only entry in P Co's individual statement of profit or loss will be to record dividends received. For the year ended 31 December 20X8, P Co will:

DEBIT	Cash	$1,500	
CREDIT	Income from shares in associates		$1,500

In the **consolidated accounts** of P Co equity accounting principles will be used to account for the investment in A Co. Consolidated profit after tax will include the group's share of A Co's profit after tax (25% × $24,000 = $6,000). To the extent that this has been distributed as dividend, it is already included in P Co's individual accounts and will automatically be brought into the consolidated results. That part of the group's share of profit in the associate which has not been distributed as dividend ($4,500) will be brought into consolidation by the following adjustment.

DEBIT	Investment in associates	$4,500	
CREDIT	Share of profit of associates		$4,500

The asset 'Investment in associates' is then stated at $64,500, being cost plus the group share of post-acquisition retained profits.

Exam focus point

A common mistake made by struggling students is to add the associate's accounts line-by-line into the rest of the group's, as though it were a subsidiary. You need to make sure you apply the equity accounting rules to associates.

3 Statement of profit or loss and statement of financial position

3.1 Consolidated statement of profit or loss

FAST FORWARD

In the **consolidated statement of profit or loss** the investing group takes credit for its **share of the after-tax profits** of associates whether or not they are distributed as dividends.

A **consolidation schedule** may be used to prepare the consolidated statement of profit or loss of a group with associates. Note the treatment of the associate's profits in the following example.

3.2 Illustration

The following **consolidation schedule** relates to the P Co group, consisting of the parent company, an 80% owned subsidiary (S Co) and an associate (A Co) in which the group has a 30% interest.

CONSOLIDATION SCHEDULE

	Group	*P Co*	*S Co*	*A Co*
	$'000	$'000	$'000	$'000
Sales revenue	1,400	600	800	300
Cost of sales	770	370	400	120
Gross profit	630	230	400	180
Administrative expenses	290	110	180	80
	340	120	220	100
Interest receivable	30	30	–	–
	370	150	220	100
Interest payable	(20)	–	(20)	–
Share of profit of associate (57× 30%)	17	–	–	
	367	150	200	100
Income tax expense				
Group	(145)	(55)	(90)	
Associate		–	–	(43)
Profit for the year	222	95	110	57
Non-controlling interest (110× 20%)	(22)			
	200			

Note:

(a) Group sales revenue, group gross profit and costs such as depreciation etc exclude the sales revenue, gross profit and costs etc of associated companies.

(b) The group share of the associated company profits is credited to group profit or loss. If the associated company has been acquired during the year, it would be necessary to deduct the pre-acquisition profits (remembering to allow for tax on current year profits).

(c) The non-controlling interest will only ever apply to subsidiary companies.

3.3 Pro-forma consolidated statement of profit or loss

The following is a **suggested layout** (using the figures given in the illustration above) for the consolidated statement of profit or loss of a company having subsidiaries as well as associated companies.

	$'000
Sales revenue	1,400
Cost of sales	(770)
Gross profit	630
Other income: interest receivable	30
Administrative expenses	(290)
Finance costs	(20)
Share of profit of associate	17
Profit before tax	367
Income tax expense	(145)
Profit for the year	222
Profit attributable to:	
Owners of the parent	200
Non-controlling interest	22
	222

3.4 Consolidated statement of financial position

FAST FORWARD

In the consolidated statement of financial position the investment in associates should be shown as:

- Cost of the investment in the associate; plus
- Group share of post acquisition profits; less
- Any amounts paid out as dividends; less
- Any amount written off the investment.

As explained earlier, the consolidated statement of financial position will contain an **asset 'Investment in associates'**. The amount at which this asset is stated will be its original cost plus the group's share of any **post-acquisition profits** which have not been distributed as dividends.

3.5 Example: consolidated statement of financial position

On 1 January 20X6 the net tangible assets of A Co amount to $220,000, financed by 100,000 $1 ordinary shares and revenue reserves of $120,000. P Co, a company with subsidiaries, acquires 30,000 of the shares in A Co for $75,000. During the year ended 31 December 20X6 A Co's profit after tax is $30,000, from which dividends of $12,000 are paid.

Show how P Co's investment in A Co would appear in the consolidated statement of financial position at 31 December 20X6.

Solution

CONSOLIDATED STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X6 (extract)

	$
Non-current assets	
Investment in associated company	
Cost	75,000
Group share of post-acquisition retained profits (30% × $18,000)	5,400
	80,400

Question

Associate I

Set out below are the draft accounts of Parent Co and its subsidiaries and of Associate Co. Parent Co acquired 40% of the equity capital of Associate Co three years ago when the latter's reserves stood at $40,000.

SUMMARISED STATEMENTS OF FINANCIAL POSITION

	Parent Co & subsidiaries	*Associate Co*
	$'000	$'000
Tangible non-current assets	220	170
Investment in Associate at cost	60	–
Loan to Associate Co	20	–
Current assets	100	50
Loan from Parent Co	–	(20)
	400	200
Share capital ($1 shares)	250	100
Retained earnings	150	100
	400	200

SUMMARISED STATEMENTS OF PROFIT OR LOSS

	Parent Co & subsidiaries	*Associate Co*
	$'000	$'000
Profit before tax	95	80
Income tax expense	35	30
Net profit for the year	60	50

Required

Prepare the summarised consolidated accounts of Parent Co.

Notes:

(1) Assume that the associate's assets/liabilities are stated at fair value.
(2) Assume that there are no non-controlling interests in the subsidiary companies.

Answer

PARENT CO
CONSOLIDATED STATEMENT OF PROFIT OR LOSS

	$'000
Net profit	95
Share of profits of associated company (50 × 40%)	20
Profit before tax	115
Income tax expense	(35)
Profit attributable to the members of Parent Co	80

PARENT CO
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$'000
Assets	
Tangible non-current assets	220
Investment in associate (see note)	84
Loan to associate	20
Current assets	100
Total assets	424
Equity and liabilities	
Share capital	250
Retained earnings (W)	174
Total equity and liabilities	424

Note

	$'000
Investment in associate	
Cost of investment	60
Share of post-acquisition retained earnings (W)	24
	84

Working

Retained earnings	*Parent & Subsidiaries*	*Associate*
	$'000	$'000
Per question	150	100
Pre-acquisition		40
Post-acquisition		60
Group share in associate ($60 × 40%)	24	
Group retained earnings	174	

Question

Alfred Co bought a 25% shareholding on 31 December 20X8 in Grimbald Co at a cost of $38,000.

During the year to 31 December 20X9 Grimbald Co made a profit before tax of $82,000 and the taxation charge on the year's profits was $32,000. A dividend of $20,000 was paid on 31 December out of these profits.

Required

Calculate the entries for the associate which would appear in the consolidated accounts of the Alfred group, in accordance with the requirements of IAS 28.

Answer

CONSOLIDATED STATEMENT OF PROFIT OR LOSS

	$
Group share of profit of associate (82,000 × 25%)	20,500
Less taxation (32,000 × 25%)	(8,000)
Share of profit of associate	12,500

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	$
Investment in associate (W)	45,500

Working

	$
Cost of investment	38,000
Share of post-acquisition retained earnings ((82,000 – 32,000 – 20,000) × 25%)	7,500
	45,500

The following points are also relevant and are similar to a parent-subsidiary consolidation situation.

(a) Use financial statements drawn up to the **same reporting date.**

(b) If this is impracticable, adjust the financial statements for **significant transactions/ events** in the intervening period. The difference between the reporting date of the associate and that of the investor must be no more than three months.

(c) Use **uniform accounting policies** for like transactions and events in similar circumstances, adjusting the associate's statements to reflect group policies if necessary.

3.6 'Upstream' and 'downstream' transactions

'Upstream' transactions are, for example, sales of assets from an associate to the investor. 'Downstream' transactions are, for example, sales of assets from the investor to an associate.

Profits and losses resulting from 'upstream' and 'downstream' transactions between an investor (including its consolidated subsidiaries) and an associate are eliminated to the extent of the investor's interest in the associate. This is very similar to the procedure for eliminating intra-group transactions between a parent and a subsidiary. The important thing to remember is that **only the group's share is eliminated**.

3.7 Example: downstream transaction

A Co, a parent with subsidiaries, holds 25% of the equity shares in B Co. During the year, A Co makes sales of $1,000,000 to B Co at cost plus a 25% mark-up. At the year-end, B Co has all these goods still in inventories.

Solution

A Co has made an unrealised profit of $200,000 (1,000,000 × 25/125) on its sales to the associate. The group's share (25%) of this must be eliminated:

DEBIT	Cost of sales (consolidated profit or loss)	$50,000	
CREDIT	Investment in associate (consolidated statement of financial position)		$50,000

Because the sale was made to the associate, the group's share of the unsold inventory forms part of the investment in the associate at the year-end. If the associate had made the sale to the parent, the adjustment would have been:

DEBIT	Cost of sales (consolidated profit or loss)	$50,000	
CREDIT	Inventories (consolidated statement of financial position)		$50,000

3.8 Associate's losses

When the equity method is being used and the investor's share of losses of the associate equals or exceeds its interest in the associate, the investor should **discontinue** including its share of further losses. The investment is reported at nil value. After the investor's interest is reduced to nil, **additional losses** should only be recognised where the investor has incurred obligations or made payments on behalf of the associate (for example, if it has guaranteed amounts owed to third parties by the associate).

3.9 Impairment losses

IFRS 9 sets out a list of indications that a financial asset (including an associate) may have become impaired. Any impairment loss is recognised in accordance with IAS 36 *Impairment of assets* for each associate individually.

In the case of an associate, any impairment loss will be deducted from the carrying value in the statement of financial position.

The working would be as follows.

	$
Cost of investment	X
Share of post-acquisition retained earnings	X
	X
Impairment loss	(X)
Investment in associate	X

Exam focus point

It is not unusual in the exam to have both an associate and a subsidiary to account for in a consolidation.

The statements of financial position of J Co and its investee companies, P Co and S Co, at 31 December 20X5 are shown below.

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	J Co	*P Co*	*S Co*
	$'000	$'000	$'000
Non-current assets			
Freehold property	1,950	1,250	500
Plant and machinery	795	375	285
Investments	1,500	–	–
	4,245	1,625	785
Current assets			
Inventory	575	300	265
Trade receivables	330	290	370
Cash	50	120	20
	955	710	655
Total assets	5,200	2,335	1,440
Equity and liabilities			
Equity			
Share capital – $1 shares	2,000	1,000	750
Retained earnings	1,460	885	390
	3,460	1,885	1,140
Non-current liabilities			
12% loan stock	500	100	
Current liabilities			
Trade payables	680	350	300
Bank overdraft	560	–	–
	1,240	350	300
Total equity and liabilities	5,200	2,335	1,440

Additional information

(a) J Co acquired 600,000 ordinary shares in P Co on 1 January 20X0 for $1,000,000 when the retained earnings of P Co were $200,000.

(b) At the date of acquisition of P Co, the fair value of its freehold property was considered to be $400,000 greater than its value in P Co's statement of financial position. P Co had acquired the property in January 20W0 and the buildings element (comprising 50% of the total value) is depreciated on cost over 50 years.

(c) J Co acquired 225,000 ordinary shares in S Co on 1 January 20X4 for $500,000 when the retained earnings of S Co were $150,000.

(d) P Co manufactures a component used by both J Co and S Co. Transfers are made by P Co at cost plus 25%. J Co held $100,000 inventory of these components at 31 December 20X5. In the same period J Co sold goods to S Co of which S Co had $80,000 in inventory at 31 December 20X5. J Co had marked these goods up by 25%.

(e) The goodwill in P Co is impaired and should be fully written off. An impairment loss of $92,000 is to be recognised on the investment in S Co.

(f) Non-controlling interest is valued at full fair value. P Co shares were trading at $1.60 just prior to the acquisition by J Co.

Required

Prepare, in a format suitable for inclusion in the annual report of the J Group, the consolidated statement of financial position at 31 December 20X5.

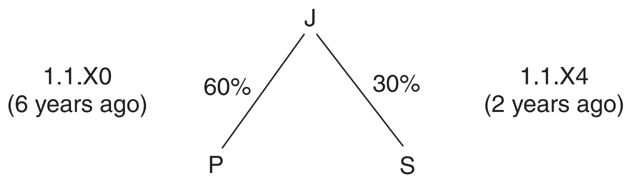
Answer

J GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X5

	$'000
Non-current assets	
Freehold property (W2)	3,570.00
Plant and machinery (795 + 375)	1,170.00
Investment in associate (W7)	475.20
	5,215.20
Current assets	
Inventory (W3)	855.00
Receivables (330 + 290)	620.00
Cash (50 + 120)	170.00
	1,645.00
Total assets	6,860.20
Equity and liabilities	
Equity	
Share capital	2,000.00
Retained earnings (W8)	1,792.20
	3,792.20
Non-controlling interest (W9)	878.00
	4,670.20
Non-current liabilities	
12% loan stock (500 + 100)	600.00
Current liabilities (680 + 560 + 350)	1,590.00
Total equity and liabilities	6,860.20

Workings

1 *Group structure*



2 *Freehold property*

	$'000
J Co	1,950
P Co	1,250
Fair value adjustment	400
Additional depreciation (400 × 50% ÷ 40) × 6 years (20X0-20X5)	(30)
	3,570

3 *Inventory*

	$'000
J Co	575
P Co	300
PUP ($100 \times {}^{25}/_{125}$) (W4)	(20)
	855

4 *Unrealised profit (PUP)*

	$'000
On sales by P to J (parent co) 100 × 25/125	20.0
On sales by J to S (associate) 80 × 25/125 × 30%	4.8

5 *Fair value adjustments*

	Difference at acquisition	Difference now
	$'000	$'000
Property	400	400
Additional depreciation: 200 × 6/40	–	(30)
	400	370

∴ Charge $30,000 to retained earnings

6 *Goodwill*

	$'000	$'000
P Co		
Consideration transferred		1,000
Non-controlling interest (400 × $1.60)		640
Net assets acquired		
Share capital	1,000	
Retained earnings	200	
Fair value adjustment	400	
		(1,600)
Goodwill at acquisition		40
Impairment loss		(40)
		0

7 *Investment in associate*

	$'000
Cost of investment	500.00
Share of post-acquisition profit (390 – 150) × 30%	72.00
Less PUP	(4.80)
Less impairment loss	(92.00)
	475.20

8 *Retained earnings*

	J	*P*	*S*
	$'000	$'000	$'000
Retained earnings per question	1,460.0	885.0	390.0
Adjustments			
Unrealised profit (W4)	(4.8)	(20.0)	
Fair value adjustments (W5)		(30.0)	
Impairment loss (P)		(40.0)	
		795.0	390.0
Less pre-acquisition reserves		(200.0)	(150.0)
	1,455.20	595.0	240.0
P: 60% × 595	357.00		
S: 30% × 240	72.00		
Impairment loss S	(92.00)		
	1,792.20		

9 *Non-controlling interest at reporting date*

	$'000
NCI at acquisition (W6)	640.00
Share of post-acquisition retained earnings (595 × 40%)	238.00
	878.00

Chapter Roundup

- A company investing in an associate does not have control but it does have **significant** influence. IAS 28 requires that, in consolidated financial statements, **associates** should be accounted for using **equity accounting principles**.
- In the **consolidated statement of profit or loss** the investing group takes credit for its **share of the after-tax profits** of associates, whether or not they are distributed as dividends.
- In the **consolidated statement of financial position**, the investment in associates should be shown as:
  - **Cost of the investment in the associate**; plus
  - Group share of post-acquisition profits; less
  - Any amounts paid out as dividends; less
  - Any amount written off the investment.

Quick Quiz

1. Define an associate.
2. How should associates be accounted for in the separate financial statements of the investor?
3. What is the effect of the equity method on the consolidated statement of profit or loss and statement of financial position?

Answers to Quick Quiz

1 An entity in which an investor has a significant influence, but which is not a subsidiary or a joint venture of the investor.

2 Either at cost or in accordance with IFRS 9.

3 (a) *Consolidated statement of profit or loss*. Investing company includes its share of the earnings of the associate, by adding its share of profit after tax.

(b) *Consolidated statement of financial position.* Investment in associates is initially included in assets at cost. This will increase or decrease each year according to whether the associated company makes a profit or loss.

Now try the question below from the Practice Question Bank

Number	Level	Marks	Time
Q32	Examination	40	45 mins

25

Accounting for joint arrangements

Topic list	Syllabus reference
1 IFRS 11 *Joint arrangements*	D4

Introduction

IFRS 11 covers all types of **joint arrangements**. It establishes principles for how joint operations should be distinguished from joint ventures and how to account for each type of joint arrangement in individual accounts and in consolidated accounts. Again, it is covered in full as an important standard.

Study guide

D4	**Business combinations – associates and joint arrangements**
(a)	Define associates and joint arrangements (ie joint operations and joint ventures)
(b)	Prepare consolidated financial statements to include a single subsidiary and an associated company or a joint venture (both methods)

1 IFRS 11 *Joint arrangements*

FAST FORWARD

IFRS 11 classes joint arrangements as either **joint operations** or **joint ventures**.

The classification of a joint arrangement as a joint operation or a joint venture depends upon the **rights and obligations** of the parties to the arrangement.

Joint arrangements are often found when each party can **contribute in different ways** to the activity. For example, one party may provide finance, another purchases or manufactures goods, while a third offers its marketing skills.

IFRS 11 *Joint arrangements* covers all types of joint arrangements. It is not concerned with the accounts of the joint arrangement itself (if separate accounts are maintained), but rather **how the interest in a joint arrangement is accounted for by each** party.

1.1 Definitions

Key terms

Joint arrangement. An arrangement of which two or more parties have joint control.

Joint control. The contractually agreed sharing of control of an arrangement, which exists only when decisions **about** the relevant activities require the unanimous consent of the parties sharing control.

Joint operation. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

Joint venture. A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. *(IFRS 11)*

1.2 Forms of joint arrangement

IFRS 11 classes joint arrangements as either joint operations or joint ventures. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

A **joint operation** is a joint arrangement whereby the parties that have joint control (the joint operators) have rights to the assets, and obligations for the liabilities, of that joint arrangement. A joint arrangement that is **not structured through a separate entity** is always a joint operation.

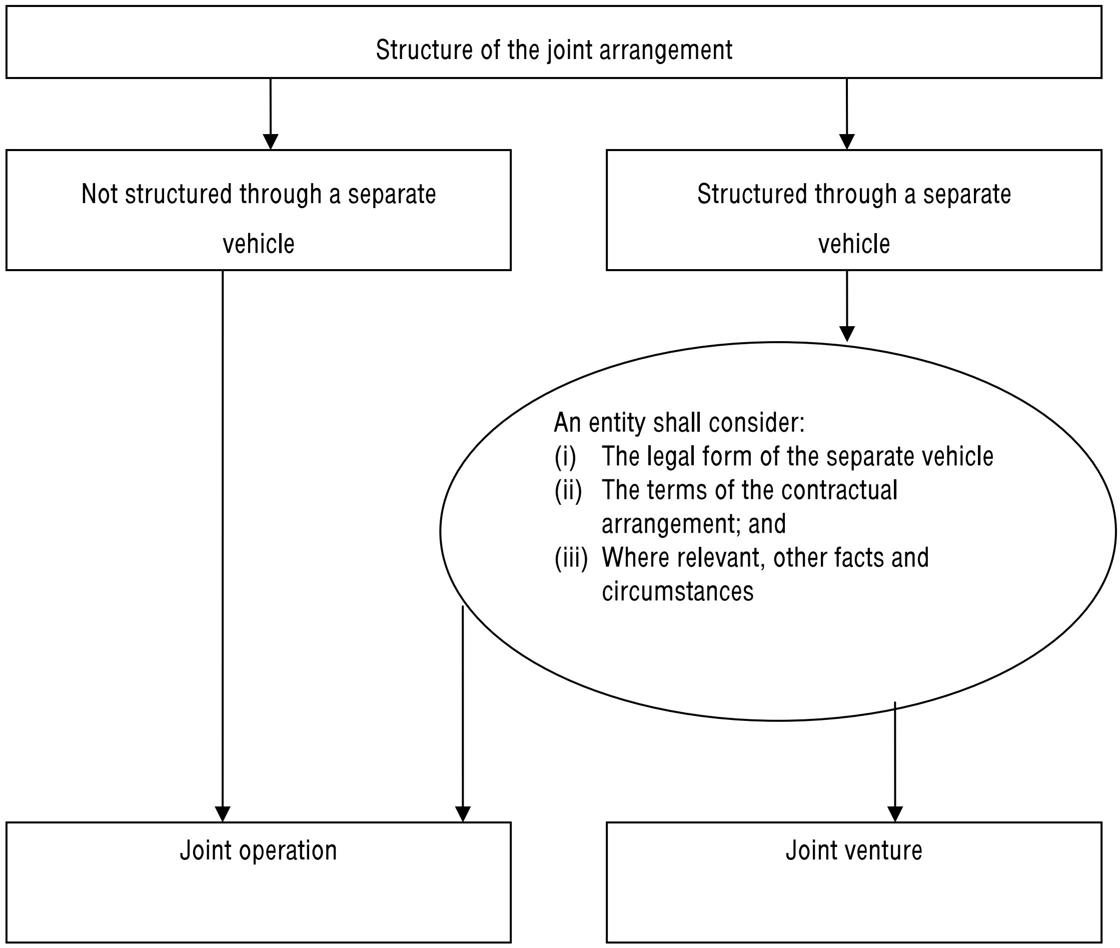
A **joint venture** is a joint arrangement whereby the parties that have **joint control** (the joint venturers) of the arrangement have **rights to the net assets** of the arrangement.

A **joint arrangement** that is structured through a **separate entity** may be either a joint operation or a joint venture. In order to ascertain the classification, the parties to the arrangement should assess the terms of the contractual arrangement together with any other facts or circumstances to assess whether they have:

- Rights to the assets and obligations for the liabilities in relation to the arrangement (indicating a joint operation)
- Rights to the net assets of the arrangement (indicating a joint venture)

Detailed guidance is provided in the appendices to IFRS 11 in order to help this assessment, giving consideration to, for example, the wording contained within contractual arrangements.

IFRS 11 summarises the basic issues that underlie the classifications in the following diagram.



1.2.1 Contractual arrangement

The existence of a contractual agreement distinguishes a joint arrangement from an investment in an associate. **If there is no contractual arrangement, then a joint arrangement does not exist**.

Evidence of a contractual arrangement could be in one of several forms.

- **Contract** between the parties
- **Minutes** of discussion between the parties
- Incorporation in the **articles or by-laws** of the joint venture

The contractual arrangement is usually **in writing**, whatever its form, and it will deal with the following issues surrounding the joint venture.

- **Its activity, duration and reporting obligations**
- The appointment of its **board of directors** (or equivalent) and the **voting rights** of the parties
- **Capital contributions** to it by the parties
- How its output, income, expenses or results are **shared** between the parties

It is the contractual arrangement which establishes **joint control** over the joint venture, so that no single party can control the activity of the joint venture on its own.

The terms of the contractual arrangement are key to deciding whether the arrangement is a joint venture or joint operation. IFRS 11 includes a table of issues to consider and explains the influence of a range of points that could be included in the contract. The table is summarised as follows.

	Joint operation	Joint venture
The terms of the contractual arrangement	The parties to the joint arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The parties to the joint arrangement have rights to the **net assets** of the arrangement (ie it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities).
Rights to assets	The parties to the joint arrangement share all interests (eg rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie no rights, title or ownership) in the assets of the arrangement.
	Joint operation	**Joint venture**
Obligations for liabilities	The parties share all liabilities, obligations, costs and expenses in a specified proportion (eg in proportion to their ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The joint arrangement is liable for the debts and obligations of the arrangement. The parties are liable to the arrangement only to the extent of: their respective: • Investments in the arrangement, or • Obligations to contribute any unpaid or additional capital to the arrangement, or • Both
	The parties to the joint arrangement are liable for claims by third parties.	Creditors of the joint arrangement do not have rights of recourse against any party.
Revenues, expenses, profit or loss	The contractual arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.
Guarantees	The provision of guarantees to third parties, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation.	

1.2.2 Section summary

- There are two **types of joint arrangement**: joint ventures and jointly controlled operations.
- A **contractual arrangement** must exist which establishes joint control.
- **Joint control** is important: one **operator** must not be able to govern the financial and operating policies of the joint venture.

Question

Joint arrangement

This question is based on Illustrative example 2 from IFRS 11.

Two real estate companies (the parties) set up a separate vehicle (Supermall) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in Supermall. The main feature of Supermall's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole.

The terms of the contractual arrangement are such that:

(a) Supermall owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre.

(b) The parties are not liable in respect of the debts, liabilities or obligations of Supermall. If Supermall is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.

(c) The parties have the right to sell or pledge their interests in Supermall.

(d) Each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in Supermall.

Required

Explain how Supermall should be classified in accordance with IFRS 11 *Joint arrangements.*

Answer

Supermall has been set up as a **separate vehicle**. As such, it could be either a joint operation or joint venture, so other facts must be considered.

There are no facts that suggest that the two real estate companies have rights to substantially all the benefits of the assets of Supermall nor an obligation for its liabilities.

Each party's liability is limited to any unpaid capital contribution.

As a result, each party has an interest in the **net assets** of Supermall and should account for it as a **joint venture** using the **equity method**.

IFRS 11 contains many examples illustrating the principles of how to classify joint arrangements, you can find them at: www.iasb.org

1.3 Accounting treatment

FAST FORWARD

The accounting treatment of joint arrangements depends on whether the arrangement is a joint venture or joint operation.

1.3.1 Accounting for joint operations

IFRS 11 requires that a joint operator recognises line-by-line the following in relation to its interest in a joint operation:

(a) Its assets, including its share of any jointly held assets
(b) Its liabilities, including its share of any jointly incurred liabilities
(c) Its revenue from the sale of its share of the output arising from the joint operation
(d) Its share of the revenue from the sale of the output by the joint operation, and
(e) Its expenses, including its share of any expenses incurred jointly.

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.

Question — **Joint operations**

Can you think of examples of situations where this type of joint venture might take place?

Answer

IFRS 1 gives examples in the oil, gas and mineral extraction industries. In such industries companies may, say, jointly control and operate on oil or gas pipeline. Each company transports its own products down the pipeline and pays an agreed proportion of the expenses of operating the pipeline (perhaps based on volume). In this case the parties have rights to assets (such as exploration permits and the oil or gas produced by the activities).

A further example is a property which is jointly controlled, each venturer taking a share of the rental income and bearing a portion of the expense.

1.3.2 Joint ventures

FAST FORWARD

IFRS 11 and **IAS 28** require **joint ventures** to be accounted for using **the equity method.**

Prior to the new group accounting standards issued in 2011, the old standard on joint ventures (IAS 31) permitted either equity accounting or proportionate consolidation to be used for joint ventures. The choice has now been removed. (Proportionate consolidation meant including the investor's share of the assets, liabilities, income and expenses of the joint venture, line by line.)

The rules for equity accounting are included in IAS 28 *Associates and joint ventures.* These have been covered in detail in Chapter 12.

1.3.3 Application of IAS 28 (2011) to joint ventures

The consolidated statement of financial position is prepared by:

- Including the interest in the joint venture at cost plus share of post-acquisition total comprehensive income
- Including the group share of the post-acquisition total comprehensive income in group reserves.

The consolidated statement of profit or loss and other comprehensive income will include:

- The group share of the joint venture's profit or loss
- The group share of the joint venture's other comprehensive income

The use of the equity method should be **discontinued** from the date on which the joint venturer ceases to have joint control over, or have significant influence on, a joint venture.

1.3.4 Transactions between a joint venturer and a joint venture

Upstream transactions

A joint venturer may **sell or contribute assets** to a joint venture so making a profit or loss. Any such gain or loss should, however, only be recognised to the extent that it reflects the substance of the transaction.

Therefore:

- Only the **gain** attributable to the interest of the other joint venturers should be recognised in the financial statements.
- The full amount of any **loss** should be recognised when the transaction shows evidence that the net realisable value of current assets is less than cost, or that there is an impairment loss.

Downstream transactions

When a joint venturer purchases assets from a joint venture, the joint venturer should not recognise its share of the profit made by the joint venture on the transaction in question until it resells the assets to an independent third party, ie until the profit is realised.

Losses should be treated in the same way, *except* losses should be recognised immediately if they represent a reduction in the net realisable value of current assets, or a permanent decline in the carrying amount of non-current assets.

1.3.5 Section summary

- **Joint operations** are accounted for by including the investor's share of assets, liabilities, income and expenses as per the contractual arrangement.
- **Joint ventures** are accounted for using the **equity method** as under IAS 28.

Chapter Roundup

- **IFRS 11** classes joint arrangements as either **joint operations** or **joint ventures**.
- The accounting treatment of joint arrangements depends on whether the arrangement is a joint venture or joint operation.
- **IFRS 11** and **IAS 28** require **joint ventures** to be accounted for using **the equity method**.

Quick Quiz

1. A joint venture is a joint arrangement whereby the parties that have________________ of the arrangement have rights to the_____________ of the arrangement.

   Complete the blanks.

2. What forms of evidence of a contractual agreement might exist?
3. How should a venturer account for its share of a joint operation?
4. How should a venturer account for its share of a joint venture?
5. A joint arrangement that is structured through a separate vehicle will always be a joint venture. *True or false*?

Answers to Quick Quiz

1. A joint venture is a joint arrangement whereby the parties that have **joint control** of the arrangement have rights to the **net assets** of the arrangement.
2. - Contractual arrangement
   - Joint control
3. (a) The assets it controls and the liabilities it incurs
   (b) The expenses it incurs and the income it earns
4. A joint venture is accounted for using the equity method as required by IAS 28 *Associates and joint ventures.*
5. False. Joint arrangements that are structured through a separate vehicle may be either joint ventures or joint arrangements. The classification will depend on whether the venturer has rights to the **net assets** of the arrangement. This will depend on the terms of the contractual arrangements.

26

Current developments

Topic list	Syllabus reference
1 Current issues in corporate reporting	A1
2 Recent documents	A1
3 Managing the change to IFRS	A1
4 International harmonisation and move towards US GAAP	A1
5 IASB Work Plan	A1

Introduction

This chapter deals with a number of current issues and developments. Having covered the regulatory framework in Part A , and some of the key standards in the other Chapters, in this chapter we look at some of the broad issues currently being debated, and the latest developments.

You should be familiar with the accounting standards covered in Section 1. If you are in a hurry or revising, go straight to the sections highlighted in this chapter as current issues.

Study guide

AI	**International sources of authority**
(1)	The International Accounting Standards Board (IASB) and the regulatory framework

1 Current issues in corporate reporting

FAST FORWARD

You should know which are the **current issues** and concentrate your studying on these. A large number of new IFRSs have come out this year.

1.1 Hot topics

The IASB workplan, as at April 2014 is reproduced in Section 7. Below are the examinable current issues, with an indication of where to find them. Most are dealt with in the chapters on the individual topic.

IFRS 10 *Consolidated financial statements*	Chapter 22 & 23
IFRS 11 *Joint arrangements*	Chapter 25
IFRS 12 *Disclosure of interests in other entities*	Chapter 19
Annual Improvements to IFRS	Section 2 of this chapter
Revision of IAS 19 *Employee benefits*	Chapter 10
Presentation of items in OCI	Chapter 23
Conceptual Framework (Joint IASB FASB project)	Chapter 2

2 Recent documents

FAST FORWARD

Annual improvements not mentioned elsewhere are included in this section.

2.1 Improvements to IFRS

The *Annual Improvements to IFRSs 2011 to 2013 Cycle* was issued in November 2012. Below is a summary of its main changes.

2.1.1 IFRS 1 First time application of IFRS

Meaning of effective IFRSs

The IASB has clarified that an entity, in its first IFRS financial statements, has the choice between applying an existing and currently effective IFRS or applying early a new or revised IFRS that is not yet mandatorily effective, provided that the new or revised IFRS permits early application. An entity is required to apply the same version of the IFRS throughout the periods covered by those first IFRS financial statements.

2.1.2 Amendments to IFRS 3 *Business combinations*

This amendment relates to the scope of exception for joint ventures and clarifies that:

(a) IFRS 3 excludes from its scope the accounting for the formation of all types of joint arrangements as defined in IFRS 11 *Joint arrangements*

(b) The scope exception in paragraph 2(a) of IFRS 3 only applies to the financial statements of the joint venture or the joint operation itself.

2.1.3 Amendment to IFRS 13 *Fair value measurement*

This amends the scope of paragraph 52 of IFRS 13 (portfolio exception), and it includes all contracts accounted for within the scope of IAS 39*Financial Instruments: recognition and measurement* or IFRS 9 *Financial instruments*, regardless of whether they meet the definition of financial assets or financial liabilities as defined in IAS 32*Financial instruments: presentation*.

2.1.4 Amendment to IAS 40 *Investment property*

This addresses the interrelationship of IFRS 3 and IAS 40, and makes it clear that the standards are not mutually exclusive when classifying property as investment property or owner-occupied property. Determining whether a specific transaction meets the definition of both a business combination as defined in IFRS 3 and investment property as defined in IAS 40 requires the separate application of both standards independently of each other.

3 Managing the change to IFRS

3.1 IFRS 1 *First-time Adoption of International Financial Reporting Standards*

FAST FORWARD

IFRS 1 gives guidance to entities applying IFRS for the first time.

The adoption of a new body of accounting standards will inevitably have a significant effect on the accounting treatments used by an entity and on the related **systems and procedures**. In 2005 many countries adopted IFRS for the first time and over the next few years other countries are likely to do the same. In addition, many Alternative Investment Market (AIM) companies and public sector companies adopted IFRS for the first time for accounting periods ending in 2009 and 2010, and US companies are likely to move increasingly to IFRS.

IFRS 1 *First-time adoption of International Financial Reporting Standards* was issued to ensure that an entity's first IFRS financial statements contain high quality information that:

(a) Is transparent for users and comparable over all periods presented;
(b) Provides a suitable starting point for accounting under IFRSs; and
(c) Can be generated at a cost that does not exceed the benefits to users.

3.1.1 General principles

An entity applies IFRS 1 in its first IFRS financial statements.

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRS by an **explicit and unreserved statement of compliance** with IFRS.

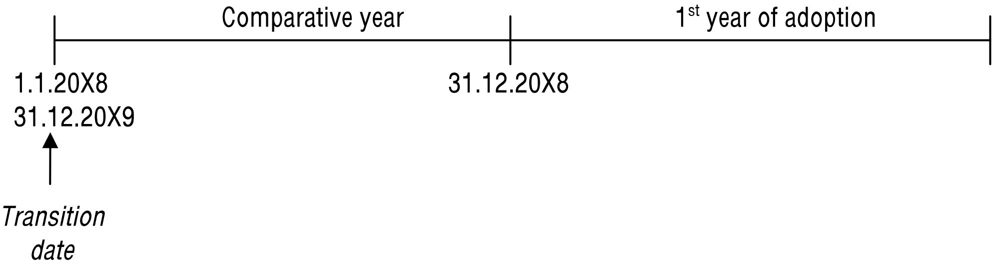
Any other financial statements (including fully compliant financial statements that did not state so) are not the first set of financial statements under IFRS.

3.1.2 Opening IFRS statement of financial position

An entity **prepares and presents** an **opening IFRS statement of financial position** at the date of transition to IFRS as a starting point for IFRS accounting.

Generally, this will be the beginning of the **earliest comparative period shown** (ie full retrospective application). Given that the entity is applying a change in accounting policy on adoption of IFRS, IAS 1 *Presentation of Financial Statements* requires the presentation of **at least three statements of financial position** (and two of each of the other statements).

Illustration: Opening IFRS SOFP



Preparation of an opening IFRS statement of financial position typically involves adjusting the amounts reported at the same date under previous GAAP.

All adjustments are recognised **directly in retained earnings** (or, if appropriate, another category of equity) not in profit or loss.

3.1.3 Estimates

Estimates in the opening IFRS statement of financial position must be consistent with estimates **made at the same date under previous GAAP** even if further information is now available (in order to comply with IAS 10).

3.1.4 Transition process

(a) **Accounting policies**

The entity should select accounting policies that comply with IFRSs effective **at the end of the first IFRS reporting period**.

These accounting policies are used in the opening IFRS statement of financial position and throughout all periods presented. The entity does not apply different versions of IFRS effective at earlier dates.

(b) **Derecognition of assets and liabilities**

Previous GAAP statement of financial position may contain items that do not qualify for recognition under IFRS.

For example, IFRS does not permit capitalisation of research, staff training and relocation costs.

(c) **Recognition of new assets and liabilities**

New assets and liabilities may need to be recognised.

For example, deferred tax balances and certain provisions such as environmental and decommissioning costs.

(d) **Reclassification of assets and liabilities**

For example, compound financial instruments need to be split into their liability and equity components.

(e) **Measurement**

Value at which asset or liability is measured may differ under IFRS.

For example, discounting of deferred tax assets/liabilities not allowed under IFRS.

3.1.5 Main exemptions from applying IFRS in the opening IFRS statement of financial position

(a) **Property, plant and equipment, investment properties and intangible assets**

(i) Fair value/previous GAAP revaluation may be used as a substitute for cost at date of transition to IFRSs.

(b) **Business combinations**

For business combinations **prior** to the date of transition to IFRSs:

(i) The same classification (acquisition or uniting of interests) is retained as under previous GAAP.

(ii) For items requiring a cost measure for IFRSs, the carrying value **at the date of the business combination** is treated as deemed cost and IFRS rules are applied from thereon.

(iii) Items requiring a fair value measure for IFRSs are revalued at the date of transition to IFRSs.

(iv) The carrying value of goodwill at the date of transition to IFRSs is the amount as reported under previous GAAP.

(c) **Employee benefits**

(i) Unrecognised actuarial gains and losses can be deemed zero at the date of transition to IFRSs. IAS 19 is applied from then on.

(d) **Cumulative translation differences on foreign operations**

(i) Translation differences (which must be disclosed in a separate translation reserve under IFRS) may be deemed zero at the date of transition to IFRS. IAS 21 is applied from then on.

(e) **Adoption of IFRS by subsidiaries, associates and joint ventures**

If a subsidiary, associate or joint venture adopts IFRS later than its parent, it measures its assets and liabilities:

Either: At the amount that would be included in the parent's financial statements, based on the parent's date of transition

Or: At the amount based on the subsidiary (associate or joint venture)'s date of transition.

Disclosure

(a) A **reconciliation of previous GAAP equity** to IFRSs is required at the date of transition to IFRSs and for the most recent financial statements presented under previous GAAP.

(b) A **reconciliation of profit** for the most recent financial statements presented under previous GAAP.

FAST FORWARD

The **change to IFRS** must be carefully managed.

3.2 Practical issues

The implementation of the change to IFRS is likely to entail careful management in most companies. Here are some of the **change management considerations** that should be addressed.

(a) **Accurate assessment of the task involved**. Underestimation or wishful thinking may hamper the effectiveness of the conversion and may ultimately prove inefficient.

(b) **Proper planning**. This should take place at the overall project level, but a **detailed** task **analysis** could be drawn up to **control work performed**.

(c) **Human resource management**. The project must be properly structured and staffed.

(d) **Training**. Where there are **skills gaps**, remedial training should be provided.

(e) **Monitoring and accountability**. A relaxed 'it will be alright on the night' attitude could spell danger. Implementation **progress** should be **monitored** and **regular meetings** set up so that participants can **personally account for what they are doing** as well as **flag up any problems** as early as possible. **Project drift should be avoided**.

(f) **Achieving milestones**. Successful completion of key steps and tasks should be appropriately acknowledged, ie what managers call 'celebrating success', so as to **sustain motivation and performance**.

(g) **Physical resourcing**. The need for IT **equipment** and **office space** should be properly assessed.

(h) **Process review**. Care should be taken not to perceive the change as a one-off quick fix. Any change in **future systems** and processes should be assessed and properly implemented.

(i) **Follow-up procedures**. As with general good management practice, the **follow up procedures** should be planned in to **make sure that the changes stick** and that any further changes are identified and addressed.

3.2.1 Financial reporting infrastructure

As well as sound management judgement, implementation of IFRS requires a sound financial reporting infrastructure. Key aspects of this include the following.

(a) A **robust regulatory framework**. For IFRS to be successful, they must be rigorously enforced.

(b) **Trained and qualified staff**. Many preparers of financial statements will have been trained in local GAAP and not be familiar with the principles underlying IFRS, let alone the detail. Some professional bodies provide conversion qualifications – for example, the ACCA's Diploma in International Financial Reporting – but the availability of such qualifications and courses may vary from country to country.

(c) **Availability and transparency of market information**. This is particularly important in the determination of fair values, which are such a key component of many IFRSs.

(d) **High standards of corporate governance and audit**. This is all the more important in the transition period, especially where there is resistance to change.

Overall, there are significant advantages to the widespread adoption of IFRS, but if the transition is to go well, there must be a realistic assessment of potential challenges.

3.3 Other implementation challenges

3.3.1 More detailed rules

Implementation of International Financial Reporting Standards entails **a great deal of work** for many companies, particularly those in countries where local GAAP has not been so onerous. For example, many jurisdictions will not have had such detailed rules about recognition, measurement and presentation of financial instruments, and many will have had no rules at all about share-based payment.

A challenge for preparers of financial statements is also **a challenge for users**. When financial statements become far more complex under IFRS than they were under local GAAP, users may find them hard to understand, and consequently of little relevance.

3.3.2 Presentation

Many developed countries have legislation requiring set formats and layouts for financial statements. For example, in the UK there is the Companies Act 2006. IFRS demands that presentation is in accordance with IAS 1 *Presentation of financial statements,* but this standard allows alternative forms of presentation. In choosing between alternatives, **countries tend to adopt the format that is closest to local GAAP**, even if this is not necessarily the best format. For example, UK companies are likely to adopt the two-statement format for the statement of profit or loss and other comprehensive income, because this is closest to the old profit and loss account and statement of total recognised gains and losses.

3.3.3 Concepts and interpretation

Although later IAS and IFRS are based to an extent on the IASB *Framework,* there is **no consistent set of principles** underlying them. The *Framework* itself is being revised, and there is controversy over the direction the revision should take. Consequently, preparers of accounts are likely to think in terms of the conceptual frameworks – if any – that they have used in developing local GAAP, and these may be

different from that of the IASB. German accounts, for example, have traditionally been aimed at the tax authorities.

Where IFRS themselves give clear guidance, this may not matter, but where there is uncertainty, preparers of accounts will fall back on their traditional conceptual thinking.

3.3.4 Choice of accounting treatment

Although many so-called 'allowed alternatives' have been eliminated from IFRS in recent years, choice of treatment remains. For example, IAS 16 *Property, plant and equipment* gives a choice of either the cost model or the revaluation model for a class of property, plant or equipment. IAS 31 *Interests in joint ventures* also gives a choice of treatment, allowing interests in jointly controlled entities to be accounted for using either proportionate consolidation or the equity method.

It could be argued that choice is a good thing, as companies should be able to select the treatment that most fairly reflects the underlying reality. However, in the context of change to IFRS, there is a danger that companies **will choose the alternative that closely matches the approach followed under local GAAP, or the one that is easier to implement**, regardless of whether this is the best choice.

3.3.5 Inconsistency in recognition or measurement methods

As well as the broader choice of which accounting model to adopt (cost or revaluation, and so on), IFRS allows further choice on recognition and measurement within a particular reporting standard. In countries where local GAAP is not very developed on this matter, preparers of accounts might well **choose the least complex option**, or the option that does not involve making a decision, rather than the correct one.

3.3.6 Timing and exemptions taken

IFRSs have provision for early adoption, and this can affect comparability, although impact of a new standard must be disclosed under IAS 8 *Accounting policies, changes in accounting estimates and errors.* Further, IFRS 1 *First time adoption of International Financial Reporting Standards* permits a number of exemptions during the periods of transition to IFRS. This gives scope for manipulation, if **exemptions are 'cherry-picked'** to produce a favourable picture.

3.3.7 Subjectivity

The extent of the impact will vary, depending on how developed local GAAP was before the transition. However, in general it is likely that **management judgement will have a greater impact** on financial statements prepared under IFRS than under local GAAP. The main reasons for this are as follows.

(a) The **volume** of rules and number of areas addressed by IFRS is likely to be greater than that under local GAAP

(b) Many issues are perhaps **addressed for the first time**, for example share-based payment

(c) IFRSs are likely to be **more complex** than local standards

(d) IFRSs allow **choice** in many cases, which leads to subjectivity

(e) Selection of **valuation method** (see above)

4 International harmonisation and move towards US GAAP

FAST FORWARD

Harmonisation in accounting is likely to come from international accounting standards, but not in the near future. There are enormous difficulties to overcome, both technical and political.

You should be able to discuss the **barriers to harmonisation** and the advantages of and **progress towards harmonisation**.

Before we look at any other countries in particular, we must consider what barriers there are to international harmonisation and why harmonisation is considered so desirable, before looking at comparative accounting systems.

4.1 Barriers to harmonisation

There are undoubtedly many barriers to international harmonisation: if there were not then greater progress would probably have been made by now. The main problems are as follows.

(a) **Different purposes of financial reporting**. In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.

(b) **Different legal systems**. These prevent the development of certain accounting practices and restrict the options available.

(c) **Different user groups**. Countries have different ideas about who the relevant user groups are and their respective importance. In the USA investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.

(d) **Needs of developing countries**. Developing countries are obviously behind in the standard setting process and they need to develop the basic standards and principles already in place in most developed countries.

(e) **Nationalism** is demonstrated in an unwillingness to accept another country's standard.

(f) **Cultural differences** result in objectives for accounting systems differing from country to country.

(g) **Unique circumstances**. Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example hyperinflation, civil war, currency restriction and so on.

(h) **The lack of strong accountancy bodies**. Many countries do not have strong independent accountancy or business bodies which would press for better standards and greater harmonisation.

These are difficult problems to overcome, and yet attempts are being made continually to do so. We must therefore consider what the perceived advantages of harmonisation are, which justify so much effort.

4.2 Advantages of global harmonisation

The advantages of harmonisation will be based on the benefits to users and preparers of accounts, as follows.

(a) **Investors**, both individual and corporate, would like to be able to compare the financial results of different companies internationally as well as nationally in making investment decisions. Differences in accounting practice and reporting can prove to be a barrier to such cross-border analysis. There is a growing amount of investment across borders and there are few financial analysts able to follow shares in international markets. For example, it is not easy for an analyst familiar with UK accounting principles to analyse the financial statements of a Dutch or German company. Harmonisation would therefore be of benefit to such analysts.

(b) **Multinational companies** would benefit from harmonisation for many reasons including the following.

  (i) Better access would be gained to foreign investor funds.

  (ii) Management control would be improved, because harmonisation would aid internal communication of financial information.

  (iii) Appraisal of foreign entities for take-overs and mergers would be more straightforward.

  (iv) It would be easier to comply with the reporting requirements of overseas stock exchanges.

  (v) Consolidation of foreign subsidiaries and associated companies would be easier.

  (vi) A reduction in audit costs might be achieved.

  (vii) Transfer of accounting staff across national borders would be easier.

(c) **Governments of developing countries** would save time and money if they could adopt international standards and, if these were used internally, governments of developing countries could attempt to control the activities of foreign multinational companies in their own country. These companies could not 'hide' behind foreign accounting practices which are difficult to understand.

(d) **Tax authorities**. It will be easier to calculate the tax liability of investors, including multinationals who receive income from overseas sources.

(e) **Regional economic groups** usually promote trade within a specific geographical region. This would be aided by common accounting practices within the region.

(f) **Large international accounting firms** would benefit as accounting and auditing would be much easier if similar accounting practices existed throughout the world.

4.3 Progress with harmonisation to date

The barriers to harmonisation may be daunting but some progress has been made. There are various bodies which are working on different aspects of harmonisation and these are discussed below. The most important of these bodies, in the light of recent developments, are the IASB and the UK ASB.

4.3.1 ASB and international standards

The UK ASB considers the development of international standards of **fundamental importance**. In addition, the UK ASB meets on a formal, and regular basis with standard-setters around the world.

Exam focus point

The UK's FRS 12 *Provisions, contingent liabilities and contingent assets* is almost identical to IAS 37 of the same name.

4.4 The EC regulation

FAST FORWARD

The EC has required that **since 2005** consolidated accounts of all listed companies should **comply with IFRS**.

As we have already seen, the EC regulations form one part of a broader programme for the harmonisation of company law in member states. The commission is uniquely the only organisation to produce **international** standards of accounting practice which are legally enforceable, in the form of directives which must be included in the national legislation of member states. The directives have been criticised as they might become constraints on the application of world-wide standards and bring accounting standardisation and harmonisation into the political arena.

The EC has adopted a regulation stating that **from 2005 consolidated accounts of listed companies have been required to comply with international financial reporting standards**. The implications of this proposal are far reaching.

Many commentators believe that, in the light of the above, it is only a matter of time before national standard setting bodies like the ASB are, in effect, replaced by the IASB and national standards fall into disuse. However, national standards were designed for the national environment, which includes small companies. Moreover, the IASB will need input and expertise from valued national standard setters like the ASB.

4.5 Convergence with US GAAP

FAST FORWARD

Convergence with EC countries has been more or less put on hold while **IFRS moves closer to US GAAP**.

4.5.1 Norwalk agreement

In October 2002, the IASB reached an agreement with the US's FASB (Financial Accounting Standards Board) (the **'Norwalk' agreement**) to undertake a short-term convergence project aimed at removing a variety of individual differences between US GAAP and International standards. The first standard resulting from this project was IFRS 5 *Non-current assets held for sale and discontinued operations* (published March 2004).

4.5.2 Principles-based approach

In 2003, an 'identical style and wording' approach was agreed for standards issued by FASB and the IASB on joint projects. Revised business combinations standards were issued as a result of this approach in 2008.

FASB also recognised the need to follow a **'principles-based' approach** to standard-setting (as the IASB has always done) in the light of recent corporate failures and scandals which have led to criticism of the 'rules-based' approach.

4.5.3 Common conceptual framework

In 2004 the IASB and FASB agreed to develop a **common conceptual framework** which would be a significant step towards harmonisation of future standards. The project has been divided into two phases:

(a) The initial focus is on particular aspects of the frameworks dealing with objectives, qualitative characteristics, elements, recognition, and measurement, giving priority to issues affecting projects for new/revised standards.

(b) Later, they will consider the applicability of those concepts to other sectors, beginning with not-for-profit entities in the private sector.

4.5.4 Memorandum of understanding

In 2006, the two Boards signed a '**Memorandum of Understanding**'. This laid down a 'roadmap of convergence' between IFRSs and US GAAP in the period 2006-2008.

The aim was to remove by 2009 the requirement for foreign companies reporting under IFRSs listed on a US stock exchange to have to prepare a reconciliation to US GAAP.

Events moved faster than expected, and in 2007 the US Securities and Exchange Commission (SEC) decided to allow non-US filers to report under IFRSs for years ended after 15 November 2007 with no reconciliation to US GAAP.

Consultation is also underway on the possibility of the use of IFRSs by US filers. In November 2008, the SEC published a proposal, titled *Roadmap for the Potential Use of Financial Statements Prepared in accordance with International Financial Reporting Standards by U.S. Issuers*. The proposed roadmap sets out milestones that, if achieved, could lead to the adoption of IFRSs in the US in 2014. It also proposes to permit the early adoption of IFRSs from 2010 for some US entities.

4.5.5 FASB/IASB projects

Some of the main results of the convergence project between FASB and the IASB have been:

(a) The issue of IFRS 5 *Non-current assets held for sale and discontinued operations*

(b) The issue of IFRS 8 *Operating segments*

(c) Revision of IAS 23 *Borrowing costs*, to align with US GAAP

(d) Revision of IAS 1 *Presentation of financial statements* and an agreement on common wording to be used in accounting standards

(e) Revision of IFRS 3 *Business combinations* and IAS 27 *Consolidated and separate financial statements*

(f) The issue of IFRS 9 *Financial instruments*, Exposure Drafts on impairment and hedging

(g) The issue of IFRS 13 *Fair value measurement*

(h) There are also Discussion Papers or Exposure drafts on the following topics:

   (i) Conceptual Framework
   (ii) Financial statements presentation
   (iii) Leases (high priority)
   (iv) Revenue recognition (high priority)

4.6 Possible setback

In July 2012, the long-awaited Stolt Report of the Securities and Exchange Commission was published. It was entitled *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers*. It discussed barriers to adoption, but did not draw any specific conclusions on adoption or endorsement of IFRSs, and was considered a disappointment in the IFRS world.

4.7 Dialogue with other key standard setters

The IASB maintains a policy of dialogue with other key standard setters around the world, in the interest of harmonising standards across the globe.

Partner standard setters are often involved in the development of Discussion Papers and Exposure Drafts on new areas.

4.7.1 China and Japan

In 2006, China officially released a new set of Chinese Accounting Standards (CASs) which are substantially converged with IFRSs, and reaffirmed its commitment to international convergence.

In 2005, the IASB and the Accounting Standards Board of Japan (ASBJ) announced a joint project to reduce differences between IFRSs and Japanese accounting standards, which is currently in progress. Consultation is also underway on the use of IFRSs in Japan from 2016.

4.7.2 Other countries

IFRS are mandatory for Brazil from 2010, Canada and South Korea from 2011, Mexico and Argentina from 2012 and phased in for India from 2012 to 2014. From 2014, US filers of financial statements will need to consult on the use of IFRS.

The following countries will **require** the use of the IFRS for SMEs (see Chapter 21) from 2013: Bahamas, Bahrain, Brazil, Cyprus, El Salvador, Lebanon, Malawi, Malaysia, Mongolia, Panama, Ireland, Kosovo, Saudi Arabia, Singapore, South Africa, Swaziland, Turkey, Uganda and the United Kingdom.

The following countries will **permit** the use of the IFRS for SMEs (see Chapter 21) from 2013: Austria, Argentina, Chile, Denmark, Israel, Namibia, Nigeria, Sri Lanka, Tanzania, Uzbekistan and the United States.

4.8 The situation today and in the future

Many organisations committed to global harmonisation have done a great deal of work towards this goal. It is the case at present, however, that fundamental disagreements exist between countries and organisations about the way forward. One of the major gulfs is between the reporting requirements in developed countries and those in non-developed countries. It will be some time before these difficulties can be overcome. The IASB is likely to be the lead body in attempting to do so, as discussed above.

5 IASB Work Plan

Below is the latest available (April 2014) version of the IASB Work Plan. Not all the topics are examinable but all examinable aspects are covered in this Text.

Work plan—projected targets as at 30 April 2014

Major IFRS				
Next major project milestone				
	2014 Q2	2014 Q3	2014 Q4	2015 Q1
IFRS 9: Financial Instruments (replacement of IAS 39)				
Classification and Measurement (Limited amendments)	Target IFRS			
Impairment	Target IFRS			
Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging [Comment period ends 17 October 2014]	Public consultation			
	2014 Q2	2014 Q3	2014 Q4	2015 Q1
Disclosure Initiative				
Amendments to IAS 1 (Disclosure Initiative)		Redeliberations		
Reconciliation of liabilities from financing activities			Target ED	
Insurance Contracts	Redeliberations			
Leases	Redeliberations			
IFRS for SMEs: Comprehensive Review 2012–2014—see **project page**				
Implementation				
Next major project milestone				
Narrow-scope amendments	2014 Q2	2014 Q3	2014 Q4	2015 Q1
Acquisition of an Interest in a Joint Operation (Proposed amendments to IFRS 11)	Target IFRS			
Annual Improvements 2012–2014 [Comment period ended 13 March 2014]	Redeliberations			
Annual Improvements 2013–2015		Target ED		
Bearer Plants (Proposed amendments to IAS 41)	Target IFRS			
Clarification of Acceptable Methods of Depreciation and Amortisation (Proposed amendments to IAS 16 and IAS 38)	Target IFRS			

Clarifications of Classification and Measurement of Share based Payment Transactions (Proposed amendment to IFRS 2)		Target ED		
Classification of liabilities (Proposed amendment to IAS 1)		Target ED		
Elimination of gains or losses arising from transactions between an entity and its associate or joint venture (Proposed amendments to IAS 28)		Target ED		
Equity Method in Separate Financial Statements (Proposed amendments to IAS 27)	Target IFRS			
Equity Method: Share of Other Net Asset Changes (Proposed amendments to IAS 28)	Target IFRS			
Fair Value Measurement: Unit of Account	Target ED			
Investment Entities: Clarifications to the accounting for interests in investment entities and applying the consolidation exemption (Proposed amendments to IFRS 10 and IAS 28)	Target ED			
Put Options Written on Non-controlling Interests (Proposed amendments to IAS 32)	Next steps TBD			
Recognition of Deferred Tax Assets for Unrealised Losses (Proposed amendments to IAS 12)		Target ED		
Sale or Contribution of Assets between an Investor and its Associate or Joint Venture (Proposed amendments to IFRS 10 and IAS 28)	Target IFRS			

Next major project milestone

Post-implementation reviews	2014 Q2	2014 Q3	2014 Q4	2015 Q1
IFRS 3 Business Combinations	Public consultation			

Conceptual Framework

Next major project milestone

	2014 Q2	2014 Q3	2014 Q4	2015 Q1
Conceptual Framework			Target ED	

Chapter Roundup

- You should know which are the **current issues** and concentrate your studying on these. A large number of new IFRSs have come out this year.
- Annual improvements not mentioned elsewhere are included in this section.
- IFRS 1 gives guidance to entities applying IFRS for the first time.
- The **change to IFRS** must be carefully managed.
- **Harmonisation** in accounting is likely to come from international accounting standards, but not in the near future. There are enormous difficulties to overcome, both technical and political.
- You should be able to discuss the **barriers to harmonisation** and the advantages of and **progress towards harmonisation**.
- The EC has required that **since 2005** consolidated accounts of all listed companies should **comply with IFRS**.
- Convergence with EC countries has more or less been put on hold while **IFRS moves closer to US GAAP**.

Quick Quiz

1 Which preparers and users of accounts can be expected to benefit from global harmonisation of accounting?

2 How many IFRSs are in existence at the moment?

3 What is the latest IFRS?

4 What is the Norwalk agreement?

5 Which standard is undergoing major revisions?

Answers to Quick Quiz

1 Investors, multinational companies, governments of developing countries, the authorities (overseas income), regional economic groups, large international accounting firms

2 13

3 IFRS 13 *Fair value measurement*, for your purposes. IFRS 15 *Revenue from Contracts with Customers* came out in May 2014, but this is after the cut-off date for your exam.

4 An agreement between the IASB and FASB to undertake a short-term convergence project aimed at removing differences between US GAAP and IFRS.

5 IAS 39, which is being replaced by IFRS 9

Practice question bank

> **Note.** The questions included within this Practice Question Bank are for practice only, and are not necessarily in the same format or at the same level of difficulty as real exam questions.

1 Setting and regulating standards

(a) Explain the objectives of the IASB.

(b) Describe how the IASB goes about developing and issuing new international financial reporting standards.

(c) Briefly describe the potential barriers to harmonisation of financial reporting standards across the globe.

(d) Briefly outline the role of IFRS Interpretations Committee.

2 Regulators

State three different regulatory influences on the preparation of the published accounts of quoted companies and briefly explain the role of each one. Comment briefly on the effectiveness of this regulatory system.

3 Europa

> **Note.** Although the dates in this question relate to first time adoption which took place in 2005, the principles are still relevant for companies which adopt IFRS for the first time. An example may be a company that becomes listed for the first time.

Europa is a listed company incorporated in the European Union. It will adopt International Financial Reporting Standards (IFRSs) for the first time in its financial statements for the year ended 31 December 2005.

The directors of Europa are unclear as to the impact of IFRS 1 First-time Adoption of International Financial Reporting Standards.

Required:

Advise the directors of Europa on the following in this question.

(a) The procedure for preparing IFRS financial statements for the first time (as required by IFRS 1)

(b) The practical steps that the company should take in order to ensure an efficient transfer to accounting under IFRS

(c) In its previous financial statements for 31 December 2003 and 2004, which were prepared under local GAAP, the company:

  (i) Made a number of routine accounting estimates, including accrued expenses and provisions, and

  (ii) did not recognise a provision for a court case arising from events that occurred in September 2004. When the court case was concluded on 30 June 2005, Europa was required to pay $10 million and paid this on 10 July 2005.

In the opinion of the directors, the company's estimates of accrued expenses and provisions under local GAAP were made on a basis consistent with IFRSs.

Required

Discuss how the matters above should be dealt with in the financial statements of Europa for the year ended 31 December 2005.

4 Conceptual framework I

(a) Explain the main purposes of the International Accounting Standards Board's *Conceptual Framework for Financial Reporting.*

(b) Identify any four user groups of financial statements and explain what information they are likely to want from them.

5 Conceptual framework II

(a) State the objectives of financial statements.

(b) State the definition of assets, liabilities and equity.

(c) Explain the IASB approach to the application relevance, faithful representation, comparability and verifiability in the preparation of financial statements.

6 Jenson **36 mins**

The timing of revenue (income) recognition has long been an area of debate and inconsistency in accounting. Industry practice in relation to revenue recognition varies widely, the following are examples of different points in the operating cycle of businesses that revenue and profit can be recognised.

(a) On the acquisition of goods
(b) During the manufacture or production of goods
(c) On delivery/acceptance of goods
(d) When certain conditions have been satisfied after the goods have been delivered
(e) Receipt of payment for credit sales
(f) On the expiry of a guarantee or warranty

In the past the 'critical event' approach has been used to determine the timing of revenue recognition. The IASB in the *Conceptual Framework* has defined the 'elements' of financial statements, and it uses these to determine when a gain or loss occurs.

Required

(a) Explain what is meant by the critical event in relation to revenue recognition and discuss the criteria used in the *Conceptual Framework* for determining when a gain or loss arises. **(2 marks)**

(b) For each of the stages of the operating cycle identified above, explain why it may be an appropriate point to recognise revenue and, where possible, give a practical example of an industry where it occurs. **(12 marks)**

(c) Jenson has entered into the following transactions/agreements in the year to 31 March 20X5.

    (i) Goods, which had a cost of $20,000, were sold to Wholesaler for $35,000 on 1 July 20X4. Jenson has an option to repurchase the goods from Wholesaler at any time within the next two years. The repurchase price will be $35,000 plus interest charged at 12% per annum from the date of sale to the date of repurchase. It is expected that Jenson will repurchase the goods.

    (ii) Jenson owns the rights to a fast food franchise. On 1 April 20X4 it sold the right to open a new outlet to Mr Cody. The franchise is for five years. Jenson received an initial fee of $50,000 for the first year and will receive $5,000 per annum thereafter. Jenson has continuing service obligations on its franchise for advertising and product development that amount to approximately $8,000 per annum for each franchised outlet. A reasonable profit margin on the provision of the continuing services is deemed to be 20% of revenues received.

    (iii) On 1 September 20X4 Jenson received subscriptions in advance of $240,000. The subscriptions are for 24 monthly publications of a magazine produced by Jenson. At the year end Jenson had produced and despatched six of the 24 publications. The total cost of producing the magazine is estimated at $192,000 with each publication costing a broadly similar amount.

Required

Describe how Jenson should treat each of the above examples in its financial statements in the year to 31 March 20X5. **(6 marks)**

(Total = 20 marks)

7 D'Urberville **36 mins**

The financial controller of D'Urberville Inc is preparing forecast statements of financial position as at 31 December 20X4, 20X5, 20X6 and 20X7.

The 20X4 forecast has been prepared and shows the following figure in respect of motor vehicles.

	$'000
Cost	540
Accumulated depreciation	130
Net book value	410

Depreciation on motor vehicles is charged at 25% on the reducing balance. A full year's depreciation is charged in the year of purchase and none in the year of sale.

The assistant accountant has collated the following information in order to help the financial controller prepare his forecast.

FORECAST PURCHASES OF MOTOR VEHICLES
FOR THE YEARS ENDED 31 DECEMBER

	20X5	*20X6*	*20X7*
	$'000	$'000	$'000
List price			
Cash purchase	180	300	450
Leased vehicles	–	400	500
Trade discount (20%)			
Cash purchase	36	60	90
Leased vehicles	–	80	100
Cash discount (5% of net price)	7	12	18
Delivery costs (paid to supplier)	10	12	15
Costs of valeting old vehicles to prepare them for sale	2	3	4
Trade-in allowances on old vehicles to be set off against finance lease first year rental		25	20
Finance lease first year rental		65	90
		(80 – 25)	(110 – 20)
Total cash to be paid to the suppliers of the new vehicles in the year of outright purchase	147	77	105
	(180 – 36 – 7 + 10)	(65 + 12)	(90 + 15)

FORECAST DISPOSALS OF MOTOR VEHICLES (AT COST)
IN THE YEARS ENDED 31 DECEMBER

	20X5	*20X6*	*20X7*
	$'000	$'000	$'000
Vehicle			
Originally acquired in years ended 31 December			
20X0	30		
20X1	40		
20X2		45	
20X3		65	
20X4			75

The following methods of purchase will be used to acquire the vehicles.

Year ended 31 December 20X5: cash purchase.

Year ended 31 December 20X6: cash purchase and finance lease agreement. A rental of $80,000 will be payable in arrears for six years. The fair value of the vehicles was $320,000.

Year ended 31 December 20X7: cash purchase and finance lease agreement. A rental of $110,000 will be payable in arrears for six years. The fair value of the vehicles was $400,000.

Required

For the non-current asset (motor vehicles) in the forecast statements of financial position of D'Urberville Inc as at 31 December 20X5, 20X6, 20X7, produce a schedule showing cost, accumulated depreciation and carrying amount. You should show all your workings and make all calculations to the nearest $'000.

(20 marks)

8 Yorana **36 mins**

Yorana Aggregates Co wish to expand their transport fleet and purchased three heavy lorries with a list price of $18,000 each. Yorana has negotiated lease finance to fund this expansion, and the company has entered into a finance lease agreement with Gregory Garages Co on 1 January 20X1. The agreement states that Yorana Aggregates will pay a deposit of $9,000 on 1 January 20X1, and two annual instalments of $24,000 on 31 December 20X1, 20X2 and a final instalment of $20,391 on 31 December 20X3.

Interest is to be calculated at 25% on the balance outstanding on 1 January each year and paid on 31 December each year.

The depreciation policy of Yorana Aggregates Co is to write off the vehicles over a four year period using the straight line method and assuming a scrap value of $1,333 for each vehicle at the end of its useful life.

The cost of the vehicles to Gregory Garages is $14,400 each.

Required

(a) Account for the above transactions in the books of Yorana Aggregates Co showing the entries in the statement of profit or loss and statement of financial position for the years 20X1, 20X2, 20X3. This is the only lease transaction undertaken by this company.

(b) Account for the above transactions in the books of Gregory Garages Co, showing the entries in the lease trading account for the years 20X1, 20X2 and 20X3. This is the only lease transaction undertaken by this company.

Calculations to the nearest $. **(20 marks)**

9 Bulwell **36 mins**

Bulwell Aggregates Co wish to expand their transport fleet and purchased three heavy lorries with a list price of $18,000 each. Robert Bulwell has negotiated lease finance to fund this expansion, and the company has entered into a finance lease agreement with Granby Garages Co on 1 January 20X1. The agreement states that Bulwell Aggregates will pay a deposit of $9,000 on 1 January 20X1, and two annual instalments of $24,000 on 31 December 20X1, 20X2 and a final instalment of $20,391 on 31 December 20X3.

Interest is to be calculated at 25% on the balance outstanding on 1 January each year and paid on 31 December each year.

The depreciation policy of Bulwell Aggregates Co is to write off the vehicles over a four year period using the straight line method and assuming a scrap value of $1,333 for each vehicle at the end of its useful life.

The cost of the vehicles to Granby Garages is $14,400 each.

Required

(a) Account for the above transactions in the books of Bulwell Aggregates Co showing the entries in the statement of profit or loss and statement of financial position for the years 20X1, 20X2, 20X3. This is the only lease transaction undertaken by this company. **(12 marks)**

(b) Account for the above transactions in the books of Granby Garages Co, showing the entries in the lease trading account for the years 20X1, 20X2 and 20X3. This is the only lease transaction undertaken by this company. **(8 marks)**

Calculations to the nearest $. **(Total = 20 marks)**

10 Winger **36 mins**

Note. This question requires the preparation of financial statements for an individual entity. Such a question is unlikely to be asked in an exam setting, however, extracts may be required in the scenario questions.

The following list of account balances relates to Winger at 31 March 20X1.

	$'000	$'000
Sales revenue (note a)		358,450
Cost of sales	185,050	
Distribution costs	28,700	
Administration expenses	15,000	
Lease rentals (note b)	20,000	
Loan note interest paid	2,000	
Dividend paid	12,000	
Property at cost (note c)	200,000	
Plant and equipment cost	154,800	
Depreciation 1 April 20X0 – plant and equipment		34,800
Development expenditure (note d)	30,000	
Profit on disposal of non-current assets (note c)		45,000
Trade accounts receivable	55,000	
Inventories: 31 March 20X1	28,240	
Cash and bank	10,660	
Trade accounts payable		29,400
Taxation: over provision in year to 31 March 20X0		2,200
Equity shares of 25c each		150,000
8% loan note (issued in 20W9)		50,000
Retained earnings 1 April 20X0		71,600
	741,450	741,450

The following notes are relevant.

(a) Included in sales revenue is $27 million, which relates to sales made to customers under sale or return agreements. The expiry date for the return of these goods is 30 April 20X1. Winger has charged a mark-up of 20% on cost for these sales.

(b) A lease rental of $20 million was paid on 1 April 20X0. It is the first of five annual payments in advance for the rental of an item of equipment that has a cash purchase price of $80 million. The auditors have advised that this is a finance lease and have calculated the implicit interest rate in the lease as 12% per annum. Leased assets should be depreciated on a straight-line basis over the life of the lease.

(c) On 1 April 20X0 Winger acquired a new property at a cost of $200 million. For the purpose of calculating depreciation only, the asset has been separated into the following elements.

Separate asset	*Cost*	*Life*
	$'000	
Land	50,000	freehold
Heating system	20,000	Ten years
Lifts	30,000	15 years
Building	100,000	50 years

The depreciation of the elements of the property should be calculated on a straight-line basis. The new property replaced an existing one that was sold on the same date for $95 million. It had cost $50 million and had a carrying value of $80 million at the date of sale. The profit on this property has been calculated on the original cost. It had not been depreciated on the basis that the depreciation charge would not be material.

Plant and machinery is depreciated at 20% on the reducing balance basis.

(d) The figure for development expenditure in the list of account balances represents the amounts deferred in previous years in respect of the development of a new product. Unfortunately, during the current year, the government has introduced legislation which effectively bans this type of product. As a consequence of this the project has been abandoned. The directors of Winger are of the opinion that writing off the development expenditure, as opposed to its previous deferment, represents a change of accounting policy and therefore wish to treat the write off as a prior period adjustment.

(e) A provision for income tax for the year to 31 March 20X1 of $15 million is required.

Required

(a) Prepare the statement of profit or loss of Winger for the year to 31 March 20X1. **(9 marks)**

(b) Prepare a statement of financial position as at 31 March 20X1 in accordance with IFRS as far as the information permits. **(11 marks)**

(Total = 20 marks)

Note. As you have not yet covered IAS 1 *Presentation of Financial Statements*, you do not need to comply with its detailed requirements.

11 Global Konstruckshen

Global Konstrukshen Co is a civil engineering company. It started work on two long-term projects during the year ended 31 December 20X0. The following figures relate to those projects at the reporting date.

	Alpine bypass	*World Ecology Centre*
	$'000	$'000
Contract price	9,000	8,000
Costs incurred to date	1,400	2,900
Estimated costs to completion	5,600	5,200
Value of work certified to date	2,800	3,000
Cash received from contractee	2,600	3,400

An old mineshaft has been discovered under the site for the World Ecology Centre and the costs of dealing with this have been taken into account in the calculation of estimated costs to completion. Global's lawyers are reasonably confident that the customer will have to bear the additional costs which will be incurred in stabilising the land. If negotiations are successful then the contract price will increase to $10m.

Global recognises turnover and profits on long-term (construction) contracts on the basis of work certified to date.

Required

(a) Calculate the figures which would appear in Global Konstrukshen's financial statements in respect of these two projects.

(b) It has been suggested that profit on construction contracts should not be recognised until the contract is completed. Briefly explain whether you believe that this suggestion would improve the quality of financial reporting for long-term contracts.

12 Provisions 45 mins

IAS 37 *Provisions, contingent liabilities and contingent assets* was issued in 1998. Prior to its publication, there was no International Accounting Standard that dealt with the general subject of accounting for provisions.

Extract prepares its financial statements to 31 December each year. During the years ended 31 December 20X0 and 31 December 20X1, the following event occurred.

Extract is involved in extracting minerals in a number of different countries. The process typically involves some contamination of the site from which the minerals are extracted. Extract makes good this contamination only where legally required to do so by legislation passed in the relevant country.

The company has been extracting minerals in Copperland since January 20W8 and expects its site to produce output until 31 December 20X5. On 23 December 20X0, it came to the attention of the directors of Extract that the government of Copperland was virtually certain to pass legislation requiring the making good of mineral extraction sites. The legislation was duly passed on 15 March 20X1. The directors of Extract estimate that the cost of making good the site in Copperland will be $2 million. This estimate is of the actual cash expenditure that will be incurred on 31 December 20X5.

Required

(a) Explain why there was a need for an accounting standard dealing with provisions, and summarise the criteria that need to be satisfied before a provision is recognised. **(12 marks)**

(b) Compute the effect of the estimated cost of making good the site on the financial statements of Extract for BOTH of the years ended 31 December 20X0 and 20X1. Give full explanations of the figures you compute.

The annual discount rate to be used in any relevant calculations is 10%.

The relevant discount factors at 10% are:

Year 4 at 10%	0.683
Year 5 at 10%	0.621

(13 marks)

(Total = 25 marks)

13 Jerzy

During the year ended 30 November 20X3, the directors of Jerzy decided to form a defined benefit pension scheme for the employees of the company and contributed cash of $160 million to it. The following details relate to the scheme at 30 November 20X3:

	$m
Present value of obligation	208
Fair value of plan assets	200
Current service cost	176
Interest cost – scheme liabilities	32
Expected return on pension scheme assets	16

The only entry in the financial statements made to date is in respect of the cash contribution which has been included in trade receivables. The directors have been uncertain as to how to deal with the above pension scheme in the consolidated financial statements.

Required:

Show how the defined benefit pension scheme should be dealt with in the financial statements for the year ended 30 November 20X3.

14 PQR **36 mins**

PQR has the following financial instruments in its financial statements for the year ended 31 December 20X5:

(a) An investment in the debentures of STU, nominal value $40,000, purchased on their issue on 1 January 20X5 at a discount of $6,000 and carrying a 4% coupon. PQR plans to hold these until their redemption on 31 December 20X8. The internal rate of return of the debentures is 8.6%.

(b) A foreign currency forward contract purchased to hedge the commitment to purchase a machine in foreign currency six months after the year end.

(c) 100,000 redeemable preference shares issued in 20X0 at $1 per share with an annual dividend payment of 6 cents per share, redeemable in 20X8 at their nominal value.

Required

(a) Advise the directors (insofar as the information permits) about the accounting for the financial instruments stating the effect of each on the gearing of the company. Your answer should be accompanied by calculations where appropriate. **(10 marks)**

PQR owns 100,000 barrels of crude oil which were purchased on 1 July 20X5 at a cost of $26.00 per barrel.

In order to hedge the fluctuation in the market value of the oil, PQR signs a futures contract on the same date to deliver 100,000 barrels of oil on 31 March 20X6 at a futures price of $27.50 per barrel.

Due to unexpected increased production by OPEC, the market price of oil on 31 December 20X5 slumped to $22.50 per barrel and the futures price for delivery on 31 March 20X6 was $23.25 per barrel at that date.

Required

(b) Explain the impact of the transactions on the financial statements of the company for the year ended 31 December 20X5. **(10 marks)**

(Total = 20 marks)

15 Sirus **36 mins**

Sirus is a large national public limited company (plc). The directors' service agreements require each director to purchase 'B' ordinary shares on becoming a director and this capital is returned to the director on leaving the company. Any decision to pay a dividend on the 'B' shares must be approved in a general meeting by a majority of all of the shareholders in the company. Directors are the only holders of 'B' shares.

Sirus would like advice on how to account under International Financial Reporting Standards (IFRSs) for the following events in its financial statements for the year ended 30 April 20X8.

(a) The capital subscribed to Sirus by the directors and shareholders is shown as follows in the statement of financial position as at 30 April 20X8:

Equity

	$m
Ordinary 'A' shares	100
Ordinary 'B' shares	20
Retained earnings	30
Total equity	150

On 30 April 20X8 the directors had recommended that $3 million of the profits should be paid to the holders of the ordinary 'B' shares, in addition to the $10 million paid to directors under their employment contracts. The payment of $3 million had not been approved in a general meeting. The directors would like advice as to whether the capital subscribed by the directors (the ordinary 'B' shares) is equity or a liability and how to treat the payments out of profits to them. **(5 marks)**

(b) When a director retires, amounts become payable to the director as a form of retirement benefit as an annuity. These amounts are not based on salaries paid to the director under an employment contract. Sirus has contractual or constructive obligations to make payments to former directors as at 30 April 20X8 as follows.

(i) Certain former directors are paid a fixed annual amount for a fixed term beginning on the first anniversary of the director's retirement. If the director dies, an amount representing the present value of the future payment is paid to the director's estate.

(ii) In the case of other former directors, they are paid a fixed annual amount which ceases on death.

The rights to the annuities are determined by the length of service of the former directors and are set out in the former directors' service contracts. **(5 marks)**

(c) On 1 May 20X7 Sirus acquired another company, Marne plc. The directors of Marne, who were the only shareholders, were offered an increased profit share in the enlarged business for a period of two years after the date of acquisition as an incentive to accept the purchase offer. After this period, normal remuneration levels will be resumed. Sirus estimated that this would cost them $5 million at 30 April 20X8, and a further $6 million at 30 April 20X9. These amounts will be paid in cash shortly after the respective year ends. **(5 marks)**

(d) Sirus raised a loan with a bank of $2 million on 1 May 20X7. The market interest rate of 8% per annum is to be paid annually in arrears and the principal is to be repaid in ten years' time. The terms of the loan allow Sirus to redeem the loan after seven years by paying the interest to be charged over the seven year period, plus a penalty of $200,000 and the principal of $2 million. The effective interest rate of the repayment option is 9.1%. The directors of Sirus are currently restructuring the funding of the company and are in initial discussions with the bank about the possibility of repaying the loan within the next financial year. Sirus is uncertain about the accounting treatment for the current loan agreement and whether the loan can be shown as a current liability because of the discussions with the bank. **(5 marks)**

Required

Discuss the principles and nature of the accounting treatment of the above elements under International Financial Reporting Standards in the financial statements for the year ended 30 April 20X8. **(Total = 20 marks)**

16 DT Group 36 mins

DT, a public limited company, has decided to adopt the provisions of IFRSs for the first time in its financial statements for the year ending 30 November 20X1. The amounts of deferred tax provided as set out in the notes of the group financial statements for the year ending 30 November 20X0 were as follows:

	$m
Tax depreciation in excess of accounting depreciation	38
Other temporary differences	11
Liabilities for health care benefits	(12)
Losses available for offset against future taxable profits	(34)
	3

The following notes are relevant to the calculation of the deferred tax liability as at 30 November 20X1:

(a) DT acquired a 100% holding in a foreign company on 30 November 20X1. The subsidiary does not plan to pay any dividends for the financial year to 30 November 20X1 or in the foreseeable future. The carrying amount in DT's consolidated financial statements of its investment in the subsidiary at 30 November 20X1 is made up as follows:

	$m
Carrying value of net assets acquired excluding deferred tax	76
Goodwill (before deferred tax and impairment losses)	14
Carrying amount/cost of investment	90

The tax base of the net assets of the subsidiary at acquisition was $60m. No deduction is available in the subsidiary's tax jurisdiction for the cost of the goodwill.

Immediately after acquisition on 30 November 20X1, DT had supplied the subsidiary with inventories amounting to $30m at a profit of 20% on selling price. The inventories had not been sold by the year end and the tax rate applied to the subsidiary's profit is 25%. There was no significant difference between the fair values and carrying values on the acquisition of the subsidiary.

(b) The carrying amount of the property, plant and equipment (excluding that of the subsidiary) is $2,600m and their tax base is $1,920m. Tax arising on the revaluation of properties of $140m, if disposed of at their revalued amounts, is the same at 30 November 20X1 as at the beginning of the year. The revaluation of the properties is included in the carrying amount above.

Other taxable temporary differences (excluding the subsidiary) amount to $90m as at 30 November 20X1.

(c) The liability for health care benefits in the statement of financial position had risen to $100m as at 30 November 20X1 and the tax base is zero. Health care benefits are deductible for tax purposes when payments are made to retirees. No payments were made during the year to 30 November 20X1.

(d) Under the tax law of the country, tax losses can be carried forward for three years only. The taxable profits for the years ending 30 November were anticipated to be as follows:

20X1	*20X2*	*20X3*
$m	$m	$m
110	100	130

The auditors are unsure about the availability of taxable profits in 20X3 as the amount is based upon the projected acquisition of a profitable company. It is anticipated that there will be no future reversals of existing taxable temporary differences until after 30 November 20X3.

(e) Income tax of $165m on a property disposed of in 20X0 becomes payable on 30 November 20X4 under the deferral relief provisions of the tax laws of the country. There had been no sales or revaluations of property during the year to 30 November 20X1.

(f) Income tax is assumed to be 30% for the foreseeable future in DT's jurisdiction and the company wishes to discount any deferred tax liabilities at a rate of 4% if allowed by IAS 12.

(g) There are no other temporary differences other than those set out above. The directors of DT have calculated the opening balance of deferred tax using IAS 12 to be $280m.

Required

(a) Calculate the liability for deferred tax required by the DT Group at 30 November 20X1 and the deferred tax expense in profit or loss for the year ending 30 November 20X1 using IAS 12. **(15 marks)**

(b) Prepare a brief report for the Directors commenting on the effect that the application of IAS 12 will have on the financial statements of the DT Group. **(5 marks)**

(Total = 20 marks)

17 Courtney **18 Mins**

The following transactions relate to Courtney for the year ended 31 December 20X7.

(a) Courtney purchased 6,000 kg of materials on December 20X7 to use in their production process. The supplier is located in Erehwon where the currency is the Won.

The goods cost 300,000 Wons and have not been paid for at the year end.

The relevant exchange rates are:

1 December	US$1 = 20 Wons
31 December	US$1 = 16 Wons

Show how this transaction will be included in the financial statements at 31 December 20X7.

(b) Courtney's finance manager does not understand the difference between functional and presentation currencies. Courtney's local currency is the US$. They are a wholly owned autonomous subsidiary of a large corporation based in Europe who reports group results in Euros.

Define functional and presentation currencies in relation to Courtney and in its parent.

(10 marks)

18 Farmer Gyles

Gyles has just bought a farm in Europe and would like to know various things about IAS 41 *Agriculture*.

(a) Distinguish a biological asset from agricultural produce
(b) State four ways in which biological assets can be transformed
(c) State the general rule for **measuring** biological assets
(d) Briefly explain the issues relating to **recognition** of agricultural produce

19 Vident **36 mins**

The directors of Vident, a public limited company, are reviewing the impact of IFRS 2 *Share-based payment* on the financial statements for the year ended 31 May 20X5 as they will adopt the IFRS. However, the directors of Vident are unhappy about having to apply the standard and have put forward the following arguments as to why they should not recognise an expense for share-based payments.

(i) They feel that share options have no cost to their company and, therefore, there should be no expense charged in profit and loss.

(ii) They do not feel that the expense arising from share options under IFRS 2 actually meets the definition of an expense under the *Conceptual Framework* document.

(iii) The directors are worried about the dual impact of the IFRS on earnings per share, as an expense is shown in the statement of profit or loss and the impact of share options is recognised in the diluted earnings per share calculation.

(iv) They feel that accounting for share-based payment may have an adverse effect on their company and may discourage it from introducing new share option plans.

The following share option schemes were in existence at 31 May 20X5:

Director's name	*Grant date*	*Options granted*	*Fair value of options at grant date* $	*Exercise price* $	*Performance conditions*	*Vesting date*	*Exercise date*
J. Van Heflin	1 June 20X3	20,000	5	4.50	A	6/20X5	6/20X6
R. Ashworth	1 June 20X4	50,000	6	6	B	6/20X7	6/20X8

The price of the company's shares at 31 May 20X5 is $12 per share and at 31 May 20X4 was $12.50 per share.

The performance conditions which apply to the exercise of executive share options are as follows:

Performance Condition A

The share options do not vest if the growth in the company's earnings per share (EPS) for the year is less than 4%.

The rate of growth of EPS was 4.5% (20X3), 4.1% (20X4), 4.2% (20X5). The directors must still work for the company on the vesting date.

Performance Condition B

The share options do not vest until the share price has increased from its value of $12.50 at the grant date (1 June 20X4) to above $13.50. The director must still work for the company on the vesting date.

No directors have left the company since the issue of the share options and none are expected to leave before June 20X7. The shares vest and can be exercised on the first day of the due month.

The directors are uncertain about the deferred tax implications of adopting IFRS 2. Vident operates in a country where a tax allowance will not arise until the options are exercised and the tax allowance will be based on the option's intrinsic value at the exercise date.

Assume a tax rate of 30%.

Required

(a) Explain reasons why share-based payments should be recognised in financial statements and why the directors' arguments are unacceptable **(7 marks)**

(b) Discuss (with suitable calculations) how the directors' share options would be accounted for in the financial statements for the year ended 31 May 20X5 including the adjustment to opening balances **(7 marks)**

(c) Explain the deferred tax implications (with suitable calculations) for the company which arise from the recognition of a remuneration expense for the directors' share options **(6 marks)**

(Total = 20 marks)

20 Polymer **72 mins**

The following list of account balances has been prepared by Polymer, plastics manufacturers, on 31 May 20X8, which is the end of the company's accounting period:

	$	$
Authorised and issued 300,000 ordinary shares of $1 each, fully paid		300,000
100,000 8.4% cumulative redeemable preference shares of $1 each, fully paid		100,000
Revaluation surplus		50,000
Share premium reserve		100,000
General reserve		50,000
Retained earnings – 31 May 20X7		283,500
Patents and trademarks	215,500	
Freehold land at cost	250,000	
Leasehold property at cost	75,000	
Amortisation of leasehold property – 31 May 20X7		15,000
Factory plant and equipment at cost	150,000	
Accumulated depreciation – plant and equipment – 31 May 20X7		68,500
Furniture and fixtures at cost	50,000	
Accumulated depreciation – furniture and fixtures – 31 May 20X7		15,750
Motor vehicles at cost	75,000	
Accumulated depreciation – motor vehicles – 31 May 20X7		25,000
10% loan notes (20Y0 – 20Y5)		100,000
Trade receivables/ trade payables	177,630	97,500
Bank overdraft		51,250
Inventories – raw materials at cost – 31 May 20X7	108,400	
Purchases – raw materials	750,600	
Carriage inwards – raw materials	10,500	
Manufacturing wages	250,000	
Manufacturing overheads	125,000	
Cash	5,120	
Work in progress – 31 May 20X7	32,750	
Sales		1,526,750
Administrative expenses	158,100	
Selling and distribution expenses	116,800	
Legal and professional expenses	54,100	
Allowance for receivables – 31 May 20X8		5,750
Inventories – finished goods – 31 May 20X7	184,500	
	2,789,000	2,789,000

Additional information:

(1) Inventories at 31 May 20X8 were:

	$
Raw materials	112,600
Finished goods	275,350
Work in progress	37,800

(2) Depreciation for the year is to be charged as follows:

Plant and equipment	8% on cost – charged to production	
Furniture and fixtures	10% on cost – charged to admin	
Motor vehicles	20% on reducing value	– 25% admin
		– 75% selling and distribution

(3) Financial, legal and professional expenses include:

	$
Solicitors' fees for purchase of freehold land during year	5,000

(4) Provision is to be made for a full year's interest on the loan notes.

(5) Income tax on the profits for the year is estimated at $40,000 and is due for payment on 28 February 20X9.

(6) The directors recommended on 30 June that a dividend of 3.5c per share be paid on the ordinary share capital. No ordinary dividend was paid during the year ended 31 May 20X7.

(7) The leasehold land and buildings are held on a 50 year lease, acquired ten years ago.

Required

(a) From the information given above, prepare the statement of profit or loss and other comprehensive income of Polymer for the year to 31 May 20X8 and a statement of financial position at that date for publication in accordance with International Financial Reporting Standards.

Notes to the financial statements are not required. **(25 marks)**

(b) Explain what the IASB *Conceptual Framework* is trying to achieve. **(10 marks)**

(c) Explain and give an example of the effect on the published financial statements if the going concern convention is held not to apply. **(5 marks)**

(Total = 40 marks)

21 Hewlett 72 mins

Note. This question requires the preparation of financial statements for an individual entity. Such a question is unlikely to be asked in an exam setting, however, extracts may be required in the scenario questions.

Hewlett is a quoted company reporting under IFRSs. During the year end 31 December 20X2, the company changed its accounting policy with respect to property valuation. There are also a number of other issues that need to be finalised before the financial statements can be published.

Hewlett's trial balance from the general ledger at 31 December 20X2 showed the following balances:

		$'m	$'m
Revenue			2,648
Purchases		1,669	
Inventories at 1 January 20X2		444	
Distribution costs		514	
Administrative expenses		345	
Loan note interest paid		3	
Rental income			48
Land and buildings:	cost (including $90m land)	840	
	accumulated depreciation at 1 January 20X2		120
Plant and equipment:	cost	258	
	accumulated depreciation at 1 January 20X2		126
Investment property at 1 January 20X2		548	
Trade receivables		541	
Cash and cash equivalents		32	
50c ordinary shares			100
Share premium			244
Retained earnings at 1 January 20X2			753
Interim dividend paid		6	
General reserve			570
4% loan note repayable 20X8 (issued 20X0)			150
Trade payables			434
Proceeds from sale of equipment			7
		5,200	5,200

Further information to be taken into account:

(i) Closing inventories were counted and amounted to $388m at cost. However, shortly after the year end out-of-date inventories with a cost of $21m were sold for $14m.

(ii) At the beginning of the year, Hewlett disposed of some malfunctioning equipment for $7m. The equipment had cost $15m and had accumulated depreciation brought forward at 1 January 20X2 of $3m.

There were no other additions or disposal to property, plant and equipment in the year.

(iii) The company treats depreciation on plant and equipment as a cost of sale and on land and buildings as an administrative cost. Depreciation rates as per the company's accounting policy note are as follows:

Buildings	Straight line over 50 years
Plant and equipment	20% reducing balance

Hewlett's accounting policy is to charge a full year's depreciation in the year of an asset's purchase and none in the year of disposal. Hewlett's land and buildings were eight years old on 1 January 20X2.

(iv) On 31 December 20X2 the company revalued its land and buildings to $760m (including $100m for the land). The company follows the revaluation model of IAS 16 for its land and buildings, but no revaluations had previously been necessary. The company wishes to treat the revaluation surplus as being realised on disposal of the assets.

(v) Due to a change in the company's product portfolio plans, an item of plant with a carrying value $22m at 31 December 20X2 (after adjusting for depreciation for the year) may be impaired due to a change in use. An impairment test conducted at 31 December, revealed its fair value less costs of disposal to be $16m. The asset is now expected to generate an annual net income stream of $3.8m for the next five years at which point the asset would be disposed of for $4.2m. An appropriate discount rate is 8%. Five year discount factors at 8% are:

Simple	*Cumulative*
0.677	3.993

(vi) The income tax charge (current and deferred tax) for the year is estimated at $45m (of which $17m relates to future payable tax on the revaluation, to be charged to other comprehensive income (and the revaluation surplus)).

(vii) An interim dividend of 3c per share was paid on 30 June 20X2. A final dividend of 1.5c per share was declared by the directors on 28 January 20X3. No dividends were paid or declared in 20X1.

(viii) During the year on 1 July 20X2, Hewlett made a 1 for 4 bonus issue, capitalising its general reserve. This transaction had not yet been accounted for. The fair value of the company's shares on the date of the bonus issue was $7.50 each.

(ix) Hewlett uses the fair value model of IAS 40. The fair value of the investment property at 31 December 20X2 was $588m.

Required

(a) Prepare the statement of profit or loss and other comprehensive income and statement of changes in equity for Hewlett for the year to 31 December 20X2 and a statement of financial position at that date in accordance with IFRSs insofar as the information permits. **(30 marks)**

Notes to the financial statements are not required, but all workings should be clearly shown.

Work to the nearest $1m. Comparative information is not required.

Hewett granted 200 options on its $1 ordinary shares to 800 qualifying employees on 1 January 20X3. Each grant is conditional upon the employee being employed by Hewett until 31 December 20X5.

Hewett estimated at 1 January 20X3 that:

(i) The fair value of each option was $7.50(before adjustment for the possibility of forfeiture).

(ii) Approximately 50 employees would leave during 20X3, 40 during 20X4 and 30 during 20X5 thereby forfeiting their rights to receive the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was $1.50 and the market value of a Hewett share on 1 January 20X3 was $7.

In the event, only 40 employees left during 20X3 (and the estimate of total departures was revised down to 95 at 31 December 20X3), 20 during 20X4 (and the estimate of total departures was revised to 70 at 31 December 20X4) and none during 20X5, spread evenly during each year.

Required

The directors of Hewett have asked you to illustrate how the scheme is accounted for under IFRS 2 *Share-based Payment*.

(b) Show the double entries for the charge to profit or loss for employee services over the three years and for the share issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X5. **(6 marks)**

(c) Explain how your solution would differ had Hewett offered its employees cash based on the share value rather than share options. **(4 marks)**

(Total = 40 marks)

22 Halliday Inns **72 mins**

Note. This question requires the preparation of financial statements for an individual entity. Such a question is unlikely to be asked in an exam setting, however, extracts may be required in the scenario questions.

Halliday Inns is a quoted company which owns a large number of hotels throughout the UK. The company's latest trial balance at 31 December 20X0 is as follows.

	$'000	$'000
Administrative expenses	3,000	
Bank	300	
Payables		1,700
Distribution costs	4,000	
Food purchases	2,100	
Heating and lighting	3,000	
Hotel buildings: cost	490,000	
depreciation to date		46,200
Hotel fixtures and fittings: cost	18,000	
depreciation to date		9,400
Interest	4,950	
Interim dividend paid	1,000	
Loans, repayable 20X8		110,000
Reserves		86,000
Sales of accommodation and food		68,500
Share capital: $1 shares, fully paid		220,000
Inventory as at 31 December 20X9	400	
Taxation	50	
Wages: administrative staff	6,000	
housekeeping and restaurant staff	9,000	
	541,800	541,800

Additional information

(a) During the year the company spent a total of $12m on a new hotel and purchased new fixtures for $7m. These acquisitions have been included in the relevant trial balance totals.

(b) Hotels are to be depreciated by 2% of cost, and fixtures and fittings by 25% of the reducing balance, with a full year's depreciation to be charged in the year of acquisition or revaluation.

(c) Closing inventories of foodstuffs and other consumables were valued at $470,000 on 31 December 20X0.

(d) The balance on the taxation account is the amount remaining after the settlement of the corporation tax liability for the year ended 31 December 20W9. The directors have estimated the corporation tax liability for the year ended 31 December 20X0 at $10.2m.

(e) The directors have proposed a final dividend of $6m. This was proposed before the year end.

Required

(a) Prepare Halliday Inns' statement of profit or loss for the year ended 31 December 20X0 and its statement of financial position at that date.

Notes to the accounts are not required. **(25 marks)**

On 1 January 20X1 Halliday Inns' entered into a lease agreement to rent an asset for a six year period, at which point it will be returned to the lessor and scrapped, with annual payments of $18,420 made in advance. The market price of the asset on the same date was $86,000. The present value of minimum lease payments amounts to $84,000, discounted at the implicit interest rate shown in the lease agreement of 12.5%.

Halliday Inns' expects to sell goods produced by the asset during the first five years of the lease term, but has leased the asset for six years as this is the requirement of the lessor, and in case this expectation changes.

Required

(b) Explain how the above lease would be accounted for the year ending 31 December 20X1 including producing relevant extracts from the statement of profit or loss and statement of financial position.

You are not required to prepare the notes to the financial statements. **(15 marks)**

(Total = 40 marks)

23 Cher 36 mins

Note. To answers parts this question, you will need to refer to the statements of profit or loss in the appendix at the end of the question.

(a) Cher Inc was formed 15 years ago. As at 1 July 20X3, the issued share capital of the group was as follows, all shares being issued at par.

Ordinary $1 shares fully paid	800,000
Ordinary $1 shares 60c paid	200,000
	1,000,000

On 1 October 20X3, Cher Inc received the monies due on the partly paid shares.

Required

Calculate the earnings per share figure for the year ended 30 June 20X4, as it would appear in the financial statements of the group.

(b) On 28 February 20X5 Cher (Holdings) Co made a 1 for 4 rights issue at $1.30 per share. The actual *cum rights* price was $1.90 per share on the last day of quotation *cum rights*.

Required

(i) Calculate earnings per share for the year ended 30 June 20X5. Show the comparative figure for 20X4.

(ii) Explain the reasoning behind your calculation in part (c)(i).

(c) On 1 January 20X6, a new group Sonny Inc was formed. Its purpose was to take over the business of Cher Inc, and the need to do so arose from the fact that Cher Inc was becoming linked in the mind of the public with an unconnected, somewhat disreputable group, Sheer Inc. Sonny Inc was to issue 2 shares for every 1 share in Cher Inc. In preparing the financial statements of Sonny Inc, which is essentially a continuation of Cher Inc, the uniting of interests method allowed by IAS 22 was adopted.

Required

Calculate earnings per share for the year ended 30 June 20X6. Show the comparative figure for 20X5.

APPENDIX: STATEMENTS OF PROFIT OR LOSS

	Cher Inc		*Sonny Inc*
Year ended 30 June	*20X4*	*20X5*	*20X6*
	$'000	$'000	$'000
Turnover	2,000	3,400	4,500
Cost of sales	900	800	1,500
Gross profit	1,100	2,600	3,000
Distribution costs	150	240	310
Administrative expenses	260	410	420
Profit on ordinary activities before tax	690	1,950	2,270
Taxation	230	640	750
Profit on ordinary activities after tax	460	1,310	1,520
Dividends	100	200	250
Retained earnings for the financial year	360	1,110	1,270

(20 marks)

24 Engina **36 mins**

Engina, a foreign company, has approached a partner in your firm to assist in obtaining a local Stock Exchange listing for the company. Engina is registered in a country where transactions between related parties are considered to be normal but where such transactions are not disclosed. The directors of Engina are reluctant to disclose the nature of their related party transactions as they feel that although they are a normal feature of business in their part of the world, it could cause significant problems politically and culturally to disclose such transactions.

The partner in your firm has requested a list of all transactions with parties connected with the company and the directors of Engina have produced the following summary.

(a) Every month, Engina sells $50,000 of goods per month to Mr Satay, the financial director. The financial director has set up a small retailing business for his son and the goods are purchased at cost price for him. The annual turnover of Engina is $300 million. Additionally Mr Satay has purchased his company car from the company for $45,000 (market value $80,000). The director, Mr Satay, earns a salary of $500,000 a year, and has a personal fortune of many millions of pounds.

(b) A hotel property had been sold to a brother of Mr Soy, the Managing Director of Engina, for $4 million (net of selling cost of $0.2 million). The market value of the property was $4.3 million but in the overseas country, property prices were falling rapidly. The carrying value of the hotel was $5 million and its value in use was $3.6 million. There was an over supply of hotel accommodation due to government subsidies in an attempt to encourage hotel development and the tourist industry.

(c) Mr Satay owns several companies and the structure of the group is as follows.

Mr Satay

100% ownership of Car Co

80% ownership of Wheel Co

100% ownership of Engina Co

Engina earns 60% of its profit from transactions with Car and 40% of its profit from transactions with Wheel.

Required

Explain the reasons why it is important to disclose related party transactions and the nature of any disclosure required for the above transactions under IAS 24 Related party disclosures.

(20 marks)

25 Group accounts

In many countries, companies with subsidiaries have been required to publish group accounts, usually in the form of consolidated accounts. You are required to state why you feel the preparation of group accounts is necessary and to outline their limitations, if any.

26 Small and medium-sized entities **36 mins**

In July 2009, the IASB issued its *IFRS for SMEs*. The aim of the standard is to provide a simplified, self-contained set of accounting principles for companies which are not publicly accountable. The IFRS reduces the volume of accounting guidance applicable to SMEs by more than 90% when compared to a full set of IFRSs.

Required

(a) Discuss the advantages and disadvantages of SMEs following a separate *IFRS for SMEs* as opposed to full IFRSs. **(5 marks)**

The *IFRS for SMEs* removes choices of accounting treatment, eliminates topics that are not generally relevant to SMEs, simplifies methods for recognition and measurement and reduces the disclosure requirements of full IFRSs.

Required

(b) Give some examples from full IFRSs with choice or complex recognition and measurement requirements. Explain how the *IFRS for SME* removes this choice or simplifies the recognition and measurement requirements. **(13 marks)**

Appropriateness and quality of discussion **(2 marks)**

(Total = 20 marks)

27 Barcelona and Madrid

22 mins

Barcelona acquired 60% of Madrid's ordinary share capital on 1 October 20X2 at a price of $1.06 per share. The balance on Madrid's retained earnings at that date was $104m and the general reserve stood at $11m.

Their respective statements of financial position as at 30 September 20X6 are as follows:

	Barcelona	*Madrid*
	$m	$m
Non-current assets		
Property, plant & equipment	2,848	354
Patents	45	–
Investment in Madrid	159	–
	3,052	354
Current assets		
Inventories	895	225
Trade and other receivables	1,348	251
Cash and cash equivalents	212	34
	2,455	510
	5,507	864
Equity		
Share capital (20c ordinary shares)	920	50
Retained earnings	2,086	394
General reserve	775	46
	3,781	490
Non-current liabilities		
Long-term borrowings	558	168
Current liabilities		
Trade and other payables	1,168	183
Current portion of long-term borrowings	–	23
	1,168	206
	5,507	864

At the date of acquisition the fair values of some of Madrid's assets were greater than their carrying amounts. One line of Madrid's inventory had a fair value of $8m above its carrying amount. This inventory had all been sold by 30 September 20X6. Madrid's land and buildings had a fair value $26m above their carrying amount. $20 of this is attributable to the buildings, which had a remaining useful life of ten years at the date of acquisition.

It is group policy to value non-controlling interests at full (or fair) value. The fair value of the non-controlling interests at acquisition was $86m.

Annual impairment tests have revealed cumulative impairment losses relating to recognised goodwill of $20m to date.

Required

Produce the consolidated statement of financial position for the Barcelona Group as at 30 September 20X6.

(12 marks)

28 Reprise

36 mins

Reprise purchased 75% of Encore for $2,000,000 ten years ago when the balance on its retained earnings was $1,044,000. The statements of financial position of the two companies as at 31 March 20X4 are as follows:

	Reprise	*Encore*
	$'000	$'000
Non-current assets		
Investment in Encore	2,000	–
Land and buildings	3,350	–
Plant and equipment	1,010	2,210
Motor vehicles	510	345
	6,870	2,555
Current assets		
Inventories	890	352
Trade receivables	1,372	514
Cash and cash equivalents	89	51
	2,351	917
	9,221	3,472
Equity		
Share capital – $1 ordinary shares	1,000	500
Retained earnings	4,225	2,610
Revaluation surplus	2,500	–
	7,725	3,110
Non-current liabilities		
10% debentures	500	–
Current liabilities		
Trade payables	996	362
	9,221	3,472

The following additional information is available:

(1) Included in trade receivables of Reprise are amounts owed by Encore of $75,000. The current accounts do not at present balance due to a payment for $39,000 being in transit at the year end from Encore.

(2) Included in the inventories of Encore are items purchased from Reprise during the year for $31,200. Reprise marks up its goods by 30% to achieve its selling price.

(3) $180,000 of the recognised goodwill arising is to be written off due to impairment losses.

(4) Encore shares were trading at $4.40 just prior to acquisition by Reprise.

Required

Prepare the consolidated statement of financial position for the Reprise group of companies as at 31 March 20X4. It is the group policy to value the non-controlling interests at full (or fair) value. **(20 marks)**

29 War — 36 mins

On 1 May 20X7, War Co acquired 70% of the ordinary share capital of Peace Co by issuing to Peace Co's shareholders 500,000 ordinary $1 shares at a market value of $1.60c per share. The costs associated with the share issue were $50,000.

As at 30 June 20X7, the following financial statements for War Co and Peace Co were available.

STATEMENTS OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 20X7

	War Co	*Peace Co*
	$'000	$'000
Revenue	3,150	1,770
Cost of sales	(1,610)	(1,065)
Gross profit	1,540	705
Distribution costs	(620)	(105)
Administrative expenses	(325)*	(210)
Interest payable	(70)	(30)
Dividends from Peace Co	42	–
Profit before taxation	567	360
Income tax expense	(283)	(135)
Profit for the year	284	225

*Note. The issue costs of $50,000 on the issue of ordinary share capital are included in this figure.

Dividends paid during the year were:	War Co:	$38,000
	Peace Co:	$60,000

STATEMENTS OF FINANCIAL POSITION AT 30 JUNE 20X7

	War Co	*Peace Co*
	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment	1,750	350
Investment in Peace Co	800	–
	2,550	350
Current assets		
Inventory	150	450
Receivables	238	213
Cash	187	112
	575	775
Total assets	3,125	1,125
Equity and liabilities		
Shares of $1 each	750	100
Share premium	300	150
Retained earnings	625	450
	1,675	700
Non-current liabilities	1,050	175
Current liabilities	400	250
Total equity and liabilities	3,125	1,125

You have been asked to prepare the consolidated financial statements, taking account of the following further information.

(i) There was no impairment in the value of goodwill.

(ii) War Co accounts for pre-acquisition dividends by treating them as a deduction from the cost of the investment. Peace Co paid an ordinary dividend of 60c per share on 1 June 20X7. No dividends were proposed as at 30 June 20X7.

(iii) The profit of Peace Co may be assumed to accrue evenly over the year.

(iv) The property, plant and equipment of Peace Co had a net realisable value of $400,000 at the date of acquisition. Their fair value was $500,000. It has been decided that, as Peace Co was acquired so close to the year end, no depreciation adjustment will be made in the group accounts; the year end value will be taken as the carrying value of the property, plant and equipment in the accounts of Peace Co. The remaining assets and liabilities of Peace Co were all stated at their fair value as at 1 May 20X7.

(v) Peace Co did not issue any shares between the date of acquisition and the year end.

(vi) There were no intercompany transactions during the year.

Required

Prepare the consolidated statement of financial position and the consolidated statement of profit or loss of the War Group Co for the year ended 30 June 20X7. It is the group policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets. **(20 marks)**

30 Fallowfield and Rusholme — 36 mins

Fallowfield acquired a 60% holding in Rusholme three years ago when Rusholme's retained earnings balance stood at $16,000. Both businesses have been very successful since the acquisition and their respective statements of profit or loss for the year ended 30 June 20X8 are as follows:

	Fallowfield	*Rusholme*
	$	$
Revenue	403,400	193,000
Cost of sales	(201,400)	(92,600)
Gross profit	202,000	100,400
Distribution costs	(16,000)	(14,600)
Administrative expenses	(24,250)	(17,800)
Dividends from Rusholme	15,000	
Profit before tax	176,750	68,000
Income tax expense	(61,750)	(22,000)
PROFIT FOR THE YEAR	115,000	46,000

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	Fallowfield Retained earnings	*Rusholme Retained earnings*
	$	$
Balance at 1 July 20X7	163,000	61,000
Dividends	(40,000)	(25,000)
Profit for the year	115,000	46,000
Balance at 30 June 20X8	238,000	82,000

Additional information:

During the year Rusholme sold some goods to Fallowfield for $40,000, including 25% mark up. Half of these items were still in inventories at the year-end.

Required

(a) Produce the consolidated statement of profit or loss of Fallowfield and its subsidiary for the year ended 30 June 20X8, and an extract from the statement of changes in equity, showing retained earnings. Goodwill is to be ignored. **(15 marks)**

(b) When an acquisition takes place, the purchase consideration may be in the form of share capital. Where no suitable market price exists (for example, shares in an unquoted company) how may the fair value of the purchase consideration be estimated? **(5 marks)**

(Total = 20 marks)

31 Panther Group

27 mins

Panther operated as a single company, but in 20X4 decided to expand its operations. Panther acquired a 60% interest in Sabre on 1 July 20X4 for $2,000,000.

The statements of profit or loss and other comprehensive income of Panther and Sabre for the year ended 31 December 20X4 are as follows:

	Panther	*Sabre*
	$'000	$'000
Revenue	22,800	4,300
Cost of sales	(13,600)	(2,600)
Gross profit	9,200	1,700
Distribution costs	(2,900)	(500)
Administrative expenses	(1,800)	(300)
Finance costs	(200)	(70)
Finance income	50	–
Profit before tax	4,350	830
Income tax expense	(1,300)	(220)
PROFIT FOR THE YEAR	3,050	610
Other comprehensive income for the year, net of tax	1,600	180
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	4,650	790

Historically, Sabre had been a significant trading partner of Panther. During 20X4, Panther purchased $640,000 of goods from Sabre. Of these, $60,000 remained in inventories at the year end. Sabre makes a mark-up on cost of 20% under the transfer pricing agreement between the two companies. The fair value of the identifiable net assets of Sabre on purchase were $200,000 greater than their book value. The difference relates to properties with a remaining useful life of 20 years.

On 1 January 20X4 (to protect its supply lines), Panther had advanced a loan to Sabre amounting to $800,000 at a market interest rate of 5%. The loan is due for repayment in 20X9.

Statement of changes in equity (extracts) for the two companies:

	Panther Reserves	*Sabre Reserves*
	$'000	$'000
Balance at 1 January 20X4	12,750	2,480
Dividend paid	(900)	–
Total comprehensive income for the year	4,650	790
Balance at 31 December 20X4	16,500	3,270

Panther and Sabre had $400,000 and $150,000 of share capital in issue throughout the period respectively.

Required

Prepare the consolidated statement of profit or loss and other comprehensive income and statement of changes in equity (extract for reserves) for the Panther Group for the year ended 31 December 20X4.

No adjustments for impairment losses were necessary in the group financial statements.

Assume income and expenses (other than intragroup items) accrue evenly. **(15 marks)**

32 Hever

72 mins

Hever has held shares in two companies, Spiro and Aldridge, for a number of years. As at 31 December 20X4 they have the following statements of financial position:

	Hever	*Spiro*	*Aldridge*
	$'000	$'000	$'000
Non-current assets			
Property, plant & equipment	370	190	260
Investments	218	–	–
	588	190	260
Current assets			
Inventories	160	100	180
Trade receivables	170	90	100
Cash	50	40	10
	380	230	290
	968	420	550
Equity			
Share capital ($1 ords)	200	80	50
Share premium	100	80	30
Retained earnings	568	200	400
	868	360	480
Current liabilities			
Trade payables	100	60	70
	968	420	550

You ascertain the following additional information:

(1) The 'investments' in the statement of financial position comprise solely Hever's investment in Spiro ($128,000) and in Aldridge ($90,000).

(2) The 48,000 shares in Spiro were acquired when Spiro's retained earnings balance stood at $20,000.

The 15,000 shares in Aldridge were acquired when that company had a retained earnings balance of $150,000.

(3) When Hever acquired its shares in Spiro the fair value of Spiro's net assets equalled their book values with the following exceptions:

	$'000
Property, plant and equipment	50 higher
Inventories	20 lower (sold during 20X4)

Depreciation arising on the fair value adjustment to non-current assets since this date is $5,000.

(4) During the year, Hever sold inventories to Spiro for $16,000, which originally cost Hever $10,000. Three-quarters of these inventories have subsequently been sold by Spiro.

(5) No impairment losses on goodwill had been necessary by 31 December 20X4.

(6) It is group policy to value non-controlling interests at full (or fair) value. The fair value of the non-controlling interests at acquisition was $90,000.

Required

(a) Produce the consolidated statement of financial position for the Hever group (incorporating the associate). **(25 marks)**

Hever's activities are in the field of major construction projects. During the year ended 31 December 20X4, it enters into three separate construction contracts, each with a fixed contract price of $1,000,000. The following information relates to these contracts at 31 December 20X4:

		Contract	
	A	*B*	*C*
	$'000	$'000	$'000
Payments on account (including amounts receivable)	540	475	400
Costs incurred to date	500	550	320
Estimate costs to complete the contract	300	550	580
Estimate percentage of work completed	60%	50%	35%

Required

(b) Show how each contract would be reflected in the statement of financial position of Hever at 31 December 20X4 under IAS 11.

(c) Show how each contract would be reflected in the statement of profit or loss of Hever for the year ended 31 December 20X4 under IAS 11. **(15 marks)**

(Total = 40 marks)

Practice answer bank

1 Setting and regulating standards

(a) The objectives of the IASB are to:

(i) to **develop** a single set of **high quality, understandable, enforceable and globally accepted** international financial reporting standards (IFRSs) through its standard-setting body, the IASB;

(ii) to **Promote** the use and **rigorous application** of those standards;

(iii) to **take account** of the financial reporting needs of **emerging economies** and **small and medium-sized entities** (SMEs);

(iv) to bring about **convergence** of national accounting standards and IFRSs to **high quality solutions**.

(b) The overall agenda of the IASB will initially be set by discussion with the IFRS Advisory Council. The process for developing an individual standard would involve the following steps:

Step 1 During the early stages of a project, IASB may establish an **Advisory Committee** to give advice on issues arising in the project. Consultation between the Advisory Committee and the IFRS Advisory Council occurs throughout the project.

Step 2 IASB may develop and publish **Discussion Documents** for public comment.

Step 3 Following the receipt and review of comments, IASB would develop and publish an **Exposure Draft** for public comment.

Step 4 Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

The period of exposure for public comment is normally 90 days. However, in exceptional circumstances, proposals may be issued with a comment period of 60 days.

(c) **Barriers to harmonisation**

(i) **Different purposes of financial reporting**. In some countries the purpose is solely for tax assessment, while in others it is for investor decision-making.

(ii) **Different legal systems**. These prevent the development of certain accounting practices and restrict the options available.

(iii) **Different user groups**. Countries have different ideas about who the relevant user groups are and their respective importance. In the USA investor and creditor groups are given prominence, while in Europe employees enjoy a higher profile.

(iv) **Needs of developing countries**. Developing countries are obviously behind in the standard setting process and they need to develop the basic standards and principles already in place in most developed countries.

(v) **Nationalism** is demonstrated in an unwillingness to accept another country's standard.

(vi) **Cultural differences** result in objectives for accounting systems differing from country to country.

(vii) **Unique circumstances**. Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports, for example hyperinflation, civil war, currency restriction and so on.

(viii) **The lack of strong accountancy bodies**. Many countries do not have strong independent accountancy or business bodies which would press for better standards and greater harmonisation.

(d) The role of the IFRS Interpretations Committee is to:

(i) Review on a timely basis, newly identified financial **reporting issues not specifically addressed in IFRSs**.

(ii) **Clarify issues** where **unsatisfactory** or **conflicting** interpretations have developed, or seem likely to develop in the absence of authoritative guidance with a view to reaching a consensus on the appropriate treatment.

2 Regulators

Tutor's hint: It is best to use headings to divide up your answer, as we do here.

Stock Exchange

A listed company is a company whose shares are bought and sold on a stock exchange. This involves the signing of an agreement which requires compliance with the rules of that stock exchange. This would normally contain amongst other things the stock exchange's detailed rules on the information to be disclosed in listed companies' accounts. This, then, is one regulatory influence on a listed company's accounts. The stock exchange may enforce compliance by **monitoring accounts** and reserving the right to withdraw a company's shares from the stock exchange: ie the company's shares would no longer be traded through the stock exchange. In many countries there is, however, no statutory requirement to obey these rules.

Local legislation

In most countries, companies have to comply with the local companies legislation, which lays down **detailed requirements** on the **preparation of accounts**. Company law is often quite detailed, partly because of external influences such as EU Directives. Another reason to increase statutory regulation is that listed companies are under great pressure to **show profit growth** and an obvious way to achieve this is to **manipulate accounting policies**. If this involves breaking the law, as opposed to ignoring professional guidance, company directors may think twice before bending the rules – or, at least, this is often a government's hope.

Standard-setters

Professional guidance is given by the national and international standard-setters. Prescriptive guidance is given in accounting standards which must be applied in all accounts required to show a '**true and fair view' or 'present fairly** in all material aspects'. IFRSs and national standards are issued after extensive consultation and are revised as required to reflect economic or legal changes. In some countries, legislation requires details of non-compliance to be disclosed in the accounts. 'Defective' accounts can be revised under court order if necessary and directors signing such accounts can be prosecuted and fined (or even imprisoned).

The potential for the **IASB's influence** in this area is substantial. It must pursue **excellence in standards** with absolute rigour to fulfil that potential.

3 Europa

(a) Europa's first IFRS financial statements will be for the year ended 31 December 2005. IFRS 1 requires that at least one year's comparative figures are presented and therefore the date of transition to IFRSs is the beginning of business on 1 January 2004 (or close of business on 31 December 2003).

Therefore the procedure for adopting IFRSs is:

(i) identify accounting policies that comply with IFRSs effective at 31 December 2005 (the reporting date for the first IFRS financial statements);

(ii) restate the opening statement of financial position at 1 January 2004 (the date of transition) using these IFRSs retrospectively, by:

- recognising all assets and liabilities whose recognition is required by IFRSs;
- not recognising items as assets or liabilities if IFRSs do not permit such recognition;

- reclassifying items that were recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset liability or component of equity under IFRSs; and
- measuring all recognised assets and liabilities in accordance with IFRSs.

The company will almost certainly need to change some of its accounting policies and to adjust some of the amounts that it reported previously at the same dates using local GAAP. It should recognise these adjustments directly in retained earnings (ie, in equity).

(iii) Explain the effect of the transition from local GAAP to IFRSs, by presenting:

- a reconciliation of equity reported under local GAAP to equity under IFRSs at the date of transition and at the reporting date; and
- a reconciliation of the profit or loss reported under local GAAP to profit or loss reported under IFRSs for the period.

If Europa presented a statement of cash flows under local GAAP, it should also explain any material adjustments to the statement of cash flows.

Although the general rule is that all IFRSs should be applied retrospectively, a number of exemptions are available. These are intended to cover cases in which the cost of complying fully with a particular requirement would outweigh the benefits to users of the financial statements. Europa may choose to take advantage of any or all of the exemptions, which relate to fair values and revaluation; business combinations; employee benefits; cumulative foreign currency translation differences; compound financial instruments; and assets and liabilities of subsidiaries, associates and joint ventures.

(b) Changing from local GAAP to IFRSs is likely to be a complex process and should be carefully planned. Although local GAAP and IAS/IFRS may follow broadly the same principles there are still likely to be many important differences in the detailed requirements of individual standards.

If Europa has overseas subsidiaries outside the EU it will also need to ensure that they comply with any local reporting requirements. This may mean that subsidiaries have to prepare two sets of financial statements: one using their local GAAP; and one using IFRSs (for the consolidation).

The process will be affected by the following:

(i) The differences between local GAAP and IFRSs as they affect the group financial statements in practice. The company will need to carry out a detailed review of current accounting policies, paying particular attention to areas where there are significant differences between local GAAP and IFRSs. These will probably include deferred tax, business combinations, employee benefits and foreign currency translation. It should be possible to estimate the effect of the change by preparing pro-forma financial statements using IFRSs.

(ii) The level of knowledge of IFRSs of current finance staff (including internal auditors). It will probably be necessary to organise training and the company may need to recruit additional personnel.

(iii) The group's accounting systems. Management will need to assess whether computerised accounting systems can produce the information required to report under IFRSs. They will also need to produce new consolidation packages and accounting manuals.

Lastly, the company should consider the impact of the change to IFRSs on investors and their advisers. For this reason management should try to quantify the effect of IFRSs on results and other key performance indicators as early as possible.

(c) (i) *Accounting estimates*

Estimates under IFRSs at the date of transition must be consistent with those made at the same date under previous GAAP, (after adjustments to reflect any difference in accounting policies). The only exception to this is if the company has subsequently discovered that these estimates were in error. This is not the case here and therefore the estimates are not adjusted in the first IFRS financial statements.

(ii) *Court case*

The treatment of this depends on the reason why Europa did not recognise a provision under local GAAP at 31 December 2004.

If the requirements of local GAAP were consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, presumably the directors concluded that an outflow of economic benefit was not probable and that the recognition criteria were not met. In this case, Europa's assumptions under IFRSs are consistent with its previous assumptions under local GAAP. Europa does not recognise a provision at 31 December 2004 and accounts for the payment in the year ended 31 December 2005.

If the requirements of local GAAP were not consistent with IAS 37, Europa must determine whether it had an obligation at 31 December 2004. The directors should take account of all available evidence, including any additional evidence provided by events after the reporting date. Similarly, under IAS 10 *Events after the reporting period*, the resolution of a court case after the reporting date is an adjusting event if it confirms that the company had a present obligation at that date.

The outcome of the court case confirms that Europa had a liability in September 2004 (when the events that resulted in the case occurred). Therefore the company should recognise a provision at 31 December 2004.

4 Conceptual framework I

(a) The stated **purposes** of the *Conceptual Framework* are as follows.

(i) To assist the Board in the development of future IFRSs and in its review of existing IFRSs.

(ii) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures by reducing the number of alternative accounting treatment permitted by IFRSs.

(iii) To assist national standard-setting bodies in developing national standards.

(iv) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.

(v) To assist auditors in forming an opinion on whether financial statements comply with IFRSs.

(vi) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs.

(vii) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

(b) The people who might be **interested** in financial information about the company may be classified as follows.

(i) **Shareholders in the company**. They will be interested in the company's profitability and its ability to pay dividends. They will also be interested in the company's long term prospects

(ii) **Managers of the company**. These are people appointed by the company's owners to supervise the day-to-day activities of the company. They need information about the company's financial situation as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to take effective control and planning decisions.

(iii) **Trade contacts**, including suppliers who provide goods to the company on credit and customers who purchase the goods or services provided by the company. Suppliers will want to know about the company's ability to pay its debts; customers need to know that the company is a secure source of supply and is in no danger of having to close down.

(iv) **Providers of finance to the company**. These might include a bank which permits the company to operate an overdraft, or provides longer-term finance by granting a loan. The bank will want to ensure that the company is able to keep up with interest payments, and eventually to repay the amounts advanced.

(v) **The taxation authorities**, who will want to know about business profits in order to assess the tax payable by the company on its profits and any sales taxes.

(vi) **Employees of the company**. These should have a right to information about the company's financial situation, because their future careers and the size of their wages and salaries depend on it.

5 Conceptual framework II

(a) The *Framework* states that:

'The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.'

Such financial statements will meet the needs of most users. The information is, however, **restricted**.

(i) It is based on **past events** not expected future events.
(ii) It does not necessarily contain **non-financial information**.

The statements also show the **results** of **management's stewardship**.

(b) An asset is a **resource controlled** by an entity as a result of **past events** and from which **future economic benefits** are expected to flow to the entity.

A liability is a **present obligation** of an entity arising from **past events**, the settlement of which is expected to result in an **outflow** from the entity of **resources embodying economic benefits**.

Equity is the **residual interest** in the **assets** of the entity **after deducting all its liabilities**.

(c) **Relevance**

Relevance is the first of the *Framework*'s fundamental qualitative characteristics.

Information must be relevant, which means that it is capable of making a difference in the decisions of users. This is irrespective of whether or not it is already available from other sources.

Relevance involves information having **predictive value, confirmatory value**, or both. Predictive value means that it can be used to predict future outcomes. Confirmatory value means that it can help provide feedback about previous evaluations.

Faithful representation

Faithful representation is the second fundamental qualitative characteristic.

Information that represents faithfully has three characteristics: it is **complete**, **neutral and free from error**.

Being complete means including all information necessary for a user to understand the phenomenon being depicted. Being neutral means being without bias in the selection or presentation of information. Being free from error does not mean perfectly accurate in all respects, but that the description of phenomena, and the process used to produce reported information, are free from error.

Comparability

Comparability is the first enhancing qualitative characteristic. It means that information is comparable with similar information about other entities, and about the same entity for another period or date.

Achieving the goal of comparability involves **consistency**, which means using the same methods for the same items.

Verifiability

Verifiability is the second enhancing qualitative characteristic. If information is verifiable this means that **different knowledgeable and independent observers** could reach **consensus** that information constitutes a **faithful representation**. If information is verifiable in this way then this helps to assure users that information does faithfully represent what it purports to represent.

> **Tutorial note:**
>
> The other enhancing qualitative characteristics are **timeliness** and **understandability**.

6 Jenson

> **Tutor's hint**. This is an important conceptual subject and it is closely linked with the IASB's *Framework,* which you should have discussed, rather than IAS 18, the accounting standard on revenue recognition. You need to use your imagination to come up with examples in (b).

(a) In revenue recognition, the 'critical event' is the point in the earnings process or operating cycle at which the transaction is deemed to have been **sufficiently completed** to allow the **profit** arising from the transaction, or a distinct component part of it, to be **recognised** in income in a particular period. This has to be addressed in order to allocate transactions and their effects to different accounting periods and is a direct result of the episodic nature of financial reporting. For most companies the **normal earnings cycle** is the purchase of raw materials which are transformed through a manufacturing process into saleable goods, for which orders are subsequently received, delivery is made and then payment received.

In the past the approach has been to **match costs with revenues** and record both once the critical event has passed; in most systems this critical event has been full or **near full performance of the transaction**, so that no material uncertainties surround either the transaction being completed or the amounts arising from the transaction. This is encompassed in the notion of prudence, so that revenue is recognised only in cash or near cash form. However, any point in the cycle could be deemed to be the critical event. This approach leaves the statement of financial position as a statement of uncompleted transaction balances, comprising unexpired costs and undischarged liabilities.

In contrast, the IASB's **Conceptual Framework** defines income and expenses in terms of increases in economic benefits (income) and outflow or depletion of assets (expenses), not in terms of an earnings or matching process. The statement of financial position thus assumes primary importance in the recognition of earnings and profits. Income **can only be recognised** if there is an **increase** in the equity (ie net assets) of an entity not resulting from contributions from owners. Similarly, an expense is recognised if there is a **decrease** in the ownership interest of an entity not resulting from distributions to owners. Thus income arises from recognition of assets and derecognition of liabilities, and expenses arise from derecognition of assets and recognition of liabilities. The IASB explains that it is not possible to reverse this definitional process, ie by defining assets and liabilities in terms of income and expenses, because it has not been possible to formulate robust enough base definitions of income and expenses (partly because the choice of critical event can be subjective). Nevertheless commentators often attempt to link the two approaches by asserting that **sufficient evidence** for recognition or derecognition will be met at the critical event in the operating cycle.

(b)

> **Tutor's hint**. You can argue these examples either way – what matters is that you marshal your arguments properly. Remember that this matter is still being clarified, for example by standard setters in the UK.

On the acquisition of goods
This would be **unlikely** to be a critical event for most businesses. However, for some the acquisition of the raw materials is the most important part of the process, eg extraction of gold from a mine, or the harvesting of coffee beans. Only where the goods in question could **be sold immediately in a liquid market** would it be appropriate to recognise revenue, ie they would have to have a **commodity value**.

During the manufacture or production of goods
This is also **unlikely** to be the critical event for most businesses because **too many uncertainties** remain, eg of damaged goods or overproduction leading to obsolete inventory. An **exception** would **be long-term contracts** for the construction of specific assets, which tend to earn the constructing company revenues over the length of the contract, usually in stages, ie there is a **series of critical events** in the operating cycle. It would **not** be appropriate to recognise all the revenue at the end of the contract, because this would reflect profit earned in past periods as well as the present period. Profit is therefore recognised during manufacture or production, usually through certification by a qualified valuer. Some would argue that this is not really a critical event approach, but rather an 'accretion approach'.

On delivery/acceptance of goods
Goods are frequently sold on **credit**, whereby the vendor hands over the inventory asset and receives in its place **a financial asset of a debt** due for the price of the goods. At that point legal title passes and **full performance** has taken place. In general, the bulk of the risks of the transaction have gone and the only ones remaining relate to the creditworthiness of the purchaser and any outstanding warranty over the goods. Many trade sales take place in this way, with periods of credit allowed for goods delivered, eg 30 days. This therefore tends to be the critical event for many types of business operating cycles.

Where certain conditions have been satisfied after the goods have been delivered
In these situations the customer had a right of return of the goods without reason or penalty, but usually within a time and non-use condition. A good example is clothes retailers who **allow non-faulty goods to be returned**. Another example is that the goods need only be paid for once they are sold on to a third party. Traditionally, recognition of revenue is delayed until, eg **the deadline to allowed return passes**. However, in circumstances where goods are never returned, it might be argued that the substance of the transaction is a sale on delivery.

Receipt or payment for credit sales
Once payment is received, only warranty risk remains. A company may wait until this point to recognise income if receipt is considered uncertain, eg when goods have been sold to a company resident in a country that has exchange controls. It would otherwise be **rare** to delay recognition until payment.

On the expiry of a guarantee or warranty
Many businesses may feel unable to recognise revenue in full because of **outstanding warranties,** eg a construction company which is subject to fee retention until some time after completion of the contract. Other businesses, such as car manufacturers, may make a **general provision** for goods returned under warranty as it will not be possible to judge likely warranty costs under individual contracts.

(c) (i) This agreement is worded as a **sale**, but it is fairly obvious from the terms and assessed substance that it is in fact a **secured loan**. Jensen should therefore continue to recognise the inventory on statement of financial position and should treat the receipt from Wholesaler as a loan, not revenue. Finance costs will be charged to the statement of profit or loss, of $35,000 $\times$ 12% $\times$ 9/12 = £3,150.

(ii) The initial fee of $50,000 should be spread evenly over the term of the franchise. This will give revenue of $10,000 in year 1 and $15,000 thereafter. The profit will therefore be 20% for year 1 and approximately 46% for years 2 – 5.

(iii) The cost of the first six months' publications is $192,000 $\div$ 24 $\times$ 6 = $48,000. On an accruals basis, income of $240,000 $\div$ 24 $\times$ 6 = $60,000 should be recognised. This would

leave deferred income of \$240,000 – \$60,000 = \$180,000 in Jenson's statement of financial position (ie as a liability). As in (ii), however, this may not represent a liability. In fact, the liability of the company may only extend to the cost of the future publications, ie \$192,000 – \$48,000 = \$144,000. This would allow Jenson to **recognise all the profit** on the publications **immediately**. In the absence of an updated accounting standard on revenue recognition, it will be necessary to consider the extent of Jenson's commitments under this arrangement.

7 D'Urberville

Tutor's hint. The figures for 20X5 are fairly easy. For 20X6 and 20X7 you have a finance lease to deal with, which requires a bit more thought.

Non-current assets

SCHEDULE OF MOTOR VEHICLES
FOR THE YEARS ENDED 31 DECEMBER 20X5, 20X6, 20X7

			$'000
20X5			
Cost:	At 1 January 20X5		540
	Additions		147
	Disposals		70
	At 31 December 20X5		617
Accumulated depreciation:		At 1 January 20X5	130
		Disposals (W1)	50
		Charge for year 25% × (617 – (130 – 50))	134
		At 31 December 20X5	214
Carrying amount at 31 December 20X5			403
20X6			
Cost:	At 1 January 20X6		617
	Additions*		252
	Held under finance leases		320
	Disposals		110
	At 31 December 20X6		1,079
Accumulated depreciation:		At 1 January 20X6	214
		Disposals (W2)	68
		Charge for year 25% (759 – (214 – 68)) + (25% × 320)	233
		At 31 December 20X6	379
Carrying amount at 31 December 20X6			700

***Tutor's hint**. The acquisitions in 20X6 are capitalised at cash price less trade discount (for cash purchases), plus delivery costs \$(300 – 60 + 12) = \$252,000. Disclosure of the value of the assets held subject to finance leases is required by IAS 17.

			$'000
20X7			
Cost:	At 1 January 20X7		1,079
	Additions**		375
	Held under finance leases		400
	Disposals		75
	At 31 December 20X7		1,779
Accumulated depreciation:		At 1 January 20X7	379
		Disposals (W3)	(43)
		Charge for year 25% (1,379 – (379 – 43) + (400 × 25%))	361
		At 31 December 20X7	697
Carrying amount at 31 December 20X5			1,082

Tutor's hint. The acquisitions in 20X7 are capitalised at cash price less trade discount (for cash purchase) plus delivery cost: $(450 – 90 + 15) = $375.

Workings

1 Accumulated depreciation on 20X5 disposals

Vehicles acquired in 20X0:

		$
20X0	25% × $30,000	7,500
20X1	25% × $(30,000 – 7,500)	5,625
20X2	25% × $(30,000 – (7,500 + 5,625))	4,219
20X3	25% × $(30,000 – (7,500 + 5,625 + 4,219))	3,164
20X4	25% × $(30,000 – (7,500 + 5,625 + 4,219 + 3,164))	2,373
Total		22,881

Vehicles acquired in 20X1:

		$
20X1	25% × $40,000	10,000
20X2	25% × $(40,000 – 10,000)	7,500
20X3	25% × $(40,000 – (10,000 + 7,500))	5,625
20X4	25% × $(40,000 – (10,000 + 8,500 + 5,625))	4,219
Total		27,344

Total accumulated depreciation on disposals: $(22,881 + 27,344) = $50,225.

2 *Accumulated depreciation on 20X6 disposals*

Vehicles acquired in 20X2:

		$
20X2	25% × $45,000	11,250
20X3	25% × $(45,000 – 11,250)	8,438
20X4	25% × $(45,000 – (11,250 + 8,438))	6,328
20X5	25% × $(45,000 – (11,250 + 8,438 + 6,328))	4,746
Total		30,762

Vehicles acquired in 20X3:

		$
20X3	25% × $65,000	16,250
20X4	25% × $(65,000 – 16,250)	12,188
20X5	25% × $(65,000 – (16,250 + 12,188))	9,141
Total		37,579

Total accumulated depreciation on 20X6 disposals $(30,762 + 37,579) = $68,341

3 *Accumulated depreciation on 20X7 disposals*

Vehicles acquired in 20X2:

		$
20X4	25% × $75,000	18,750
20X5	25% × $(75,000 – 18,750)	14,063
20X6	25% × $(75,000 – (18,750 + 14,063)	10,547
Total		43,360

Tutor's hint. Note that the question does not ask for the details of the obligations under the finance leases which would be disclosed under long and short term payables in accordance with the requirements of IAS 17.

8 Yorana

Tutor's hint. The most important part of this question is the working apportioning the lease instalments between interest and the capital. The rest of the accounting follows on for this.

(a) BOOKS OF YORANA AGGREGATES CO

LORRIES ACCOUNT

20X1		$
1 Jan	Gregory Garages	54,000

PROVISION FOR DEPRECIATION ON LORRIES

20X1		$	*20X1*		$
			31 Dec	Statement of profit or loss: ¼ ×	
31 Dec	Balance c/d	12,500		$(54,000 – (3 × 1,333))	12,500
20X2			*20X2*		
31 Dec	Balance c/d	25,000	1 Jan	Balance b/d	12,500
			31 Dec	Statement of profit or loss	12,500
		25,000			25,000
20X3			*20X3*		
31 Dec	Balance c/d	37,500	1 Jan	Balance b/d	25,000
			31 Dec	Statement of profit or loss	12,500
		37,500			37,500
20X4			*20X4*		
31 Dec	Balance c/d	50,000	1 Jan	Balance b/d	37,500
			31 Dec	Statement of profit or loss	12,500
		50,000			50,000
			20X5		
			1 Jan	Balance b/d	50,000

Tutor's hint. The above workings are very straightforward and can be done without worrying about the leasing aspects.

LEASE INTEREST PAYABLE

20X1		$	*20X1*		$
31 Dec	Bank (W)	11,250	31 Dec	Statement of profit or loss	11,250
20X2			*20X2*		
31 Dec	Bank (W)	8,063	31 Dec	Statement of profit or loss	8,063
20X3			*20X3*		
31 Dec	Bank (W)	4,078	31 Dec	Statement of profit or loss	4,078

GREGORY GARAGES CO

20X1		$	*20X1*		$
1 Jan	Bank – deposit	9,000	1 Jan	Lorries a/c	54,000
31 Dec	Bank (W)	12,750			
	Balance c/d	32,250			
		54,000			54,000
20X2			*20X2*		
31 Dec	Bank (W)	15,937	1 Jan	Balance b/d	32,250
	Balance c/d	16,313			
		32,250			32,250
20X3			*20X3*		
31 Dec	Bank (W)	16,313	1 Jan	Balance b/d	16,313

STATEMENTS OF PROFIT OR LOSS (EXTRACTS)

	20X1	*20X2*	*20X3*	*20X4*
	$	$	$	$
Lease interest	11,250	8,063	4,078	
Depreciation on lorries	12,500	12,500	12,500	12,500

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER (EXTRACTS)

		20X1	*20X2*	*20X3*	*20X4*
		$	$	$	$
Non-current assets					
Lorries:	at cost	54,000	54,000	54,000	54,000
	Depreciation	12,500	25,000	37,500	50,000
		41,500	29,000	16,500	4,000
Current liabilities					
Finance lease obligations		15,937	16,313	–	–
Non-current liabilities					
Finance lease obligations		16,313	–	–	–

(b)

Tutor's hint. As you will see, the lessor's books are a mirror image of the lessee's.

BOOKS OF GREGORY GARAGES CO
YORANA AGGREGATES CO

20X1		$	*20X1*		$
1 Jan	Sales	54,000	1 Jan	Bank	9,000
			31 Dec	Bank	12,750
				Balance c/d	32,250
		54,000			54,000
20X2			*20X2*		
1 Jan	Balance b/d	32,250	31 Dec	Bank	15,937
				Balance c/d	16,313
		32,250			32,250
20X3			*20X3*		
1 Jan	Balance b/d	16,313	31 Dec	Bank	16,313

LEASE INTEREST RECEIVABLE

20X1		$	*20X1*			$
31 Dec	Statement of profit or loss	11,250	31 Dec	Bank		11,250
20X2			*20X2*			
31 Dec	Statement of profit or loss	8,063	31 Dec	Bank		8,063
20X3			*20X3*			
31 Dec	Statement of profit or loss	4,078	31 Dec	Bank		4,078

STATEMENTS OF PROFIT OR LOSS (EXTRACTS)

		20X1	*20X2*	*20X3*
	$	$	$	$
Sales	54,000		–	–
Cost of sales on lease	43,200		–	–
Gross profit on lease sales		10,800	–	–
Lease interest receivable		11,250	8,063	4,078

Working

Apportionment of lease instalments between interest and capital repayment.

	20X1	*20X2*	*20X3*
	$	$	$
Opening liability (after deposit)	45,000	32,250	16,313
Add interest at 25%	11,250	8,063	4,078
	56,250	40,313	20,391
Less instalment	24,000	24,000	20,391
Closing liability	32,250	16,313	Nil
Interest element as above	11,250	8,063	4,078
∴ Capital repayment	12,750	15,937	16,313
Total instalment	24,000	24,000	20,391

9 Bulwell

Tutor's hint. The most important part of this question is the working apportioning the lease instalments between interest and the capital. The rest of the accounting follows on from this.

(a) BOOKS OF BULWELL AGGREGATES CO

LORRIES ACCOUNT

20X1		$			$
1 Jan	Granby Garages	54,000			

ACCUMULATED DEPRECIATION ON LORRIES

20X1		$	*20X1*		$
			31 Dec	Statement of profit or loss: ¼ × $(54,000 – (3 × 1,333))	
31 Dec	Balance c/d	12,500			12,500
20X2			*20X2*		
31 Dec	Balance c/d	25,000	1 Jan	Balance b/d	12,500
			31 Dec	Statement of profit or loss	12,500
		25,000			25,000

20X3			*20X3*		
31 Dec	Balance c/d	37,500	1 Jan	Balance b/d	25,000
			31 Dec	Statement of profit or loss	12,500
		37,500			37,500
20X4			*20X4*		
31 Dec	Balance c/d	50,000	1 Jan	Balance b/d	37,500
			31 Dec	Statement of profit or loss	12,500
		50,000			50,000
			20X5		
			1 Jan	Balance b/d	50,000

Tutor's hint. The above workings are very straightforward and can be done without worrying about the leasing aspects.

LEASE INTEREST PAYABLE

20X1		$	*20X1*		$
31 Dec	Bank (W)	11,250	31 Dec	Statement of profit or loss	11,250
20X2			*20X2*		
31 Dec	Bank (W)	8,063	31 Dec	Statement of profit or loss	8,063
20X3			*20X3*		
31 Dec	Bank (W)	4,078	31 Dec	Statement of profit or loss	4,078

GRANBY GARAGES CO

20X1		$	*20X1*		$
1 Jan	Bank – deposit	9,000	1 Jan	Lorries a/c	54,000
31 Dec	Bank (W)	12,750			
	Balance c/d	32,250			
		54,000			54,000
20X2			*20X2*		
31 Dec	Bank (W)	15,937	1 Jan	Balance b/d	32,250
	Balance c/d	16,313			
		32,250			32,250
20X3			*20X3*		
31 Dec	Bank (W)	16,313	1 Jan	Balance b/d	16,313

STATEMENTS OF PROFIT OR LOSS (EXTRACTS)

	20X1	*20X2*	*20X3*	*20X4*
	$	$	$	$
Lease interest	11,250	8,063	4,078	
Depreciation on lorries	12,500	12,500	12,500	12,500

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER (EXTRACTS)

	20X1	*20X2*	*20X3*	*20X4*
	$	$	$	$
Non-current assets				
Lorries: at cost	54,000	54,000	54,000	54,000
Depreciation	12,500	25,000	37,500	50,000
	41,500	29,000	16,500	4,000
Current liabilities				
Finance lease obligations	15,937	16,313	–	–
Non-current liabilities				
Finance lease obligations	16,313	–	–	–

(b)

> **Tutor's hint**. As you will see, the lessor's books are a mirror image of the lessee's.

BOOKS OF GRANBY GARAGES CO

BULWELL AGGREGATES CO

		$			$
20X1			*20X1*		
1 Jan	Sales	54,000	1 Jan	Bank	9,000
			31 Dec	Bank	12,750
				Balance c/d	32,250
		54,000			54,000
20X2			*20X2*		
1 Jan	Balance b/d	32,250	31 Dec	Bank	15,937
				Balance c/d	16,313
		32,250			32,250
20X3			*20X3*		
1 Jan	Balance b/d	16,313	31 Dec	Bank	16,313

LEASE INTEREST RECEIVABLE

		$			$
20X1			*20X1*		
31 Dec	Statement of profit or loss	11,250	31 Dec	Bank	11,250
20X2			*20X2*		
31 Dec	Statement of profit or loss	8,063	31 Dec	Bank	8,063
20X3			*20X3*		
31 Dec	Statement of profit or loss	4,078	31 Dec	Bank	4,078

STATEMENTS OF PROFIT OR LOSS (EXTRACTS)

		20X1	*20X2*	*20X3*
	$	$	$	$
Sales	54,000		–	–
Cost of sales on lease	43,200		–	–
Gross profit on lease sales		10,800	–	–
Lease interest receivable		11,250	8,063	4,078

Working

Apportionment of lease instalments between interest and capital repayment.

	20X1	*20X2*	*20X3*
	$	$	$
Opening liability (after deposit)	45,000	32,250	16,313
Add interest at 25%	11,250	8,063	4,078
	56,250	40,313	20,391
Less instalment	24,000	24,000	20,391
Closing liability	32,250	16,313	Nil
Interest element as above	11,250	8,063	4,078
∴ Capital repayment	12,750	15,937	16,313
Total instalment	24,000	24,000	20,391

10 Winger

Tutorial note. As with consolidated accounts questions, a question on the preparation of a single company's accounts needs a methodical approach. Lay out proformas and fill the numbers in gradually by systematically working through the question. Points are as follows

(a) Exclude 'sale or return' goods from both sales and cost of sales.

(b) The profit on sale of property needs to be correctly accounted for.

(c) Exclude from the finance lease interest charge the $20m down payment – interest does not accrue on this.

(d) When calculating the lease payable, you need to accrue one year's interest but no more. You know that $20m is due within one year, so the non-current liability is the balance of the total amount due.

(a) WINGER

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 MARCH 20X1

	$'000
Sales revenues (358,450 – 27,000)	331,450
Cost of sales (W1)	(208,550)
Gross profit	122,900
Distribution expenses	(28,700)
Administration expenses	(15,000)
Profit on disposal of land and buildings (95,000 – 80,000)	15,000
Loss on abandonment of research project	(30,000)
Finance cost (W3)	(11,200)
Profit before tax	53,000
Income tax (15,000 – 2,200)	(12,800)
Profit for the year	40,200

(b) STATEMENT OF FINANCIAL POSITION

AS AT 31 MARCH 20X1

	$'000	$'000
Assets		
Tangible non current assets		
Property (200,000 – 6,000 (W2))		194,000
Plant and equipment (W4)		160,000
		354,000
Current assets		
Inventories (28,240 + 22,500 (W1))	50,740	
Accounts receivable (55,000 – 27,000 (W1))	28,000	
Cash	10,660	
		89,400
Total assets		443,400

	$'000	$'000
Equity and liabilities		
Equity		
Equity shares 25c each		150,000
Retained earnings (W5)		129,800
		279,800
Non-current liabilities		
Leasing obligations (W6)	47,200	
8% loan notes	50,000	
		97,200
Current liabilities		
Trade and other accounts payable (W7)	51,400	
Income tax payable	15,000	
		66,400
Total equity and liabilities		443,400

Workings

		$'000
1	*Cost of sales*	$'000
	Per question	185,050
	Less sale/return goods (27,000 × 100/120)	(22,500)
	Add depreciation (W2)	46,000
		208,550
2	*Depreciation*	$'000
	Building (100,000 ÷ 50)	2,000
	Heating system (20,000 ÷ 10)	2,000
	Lifts (30,000 ÷ 15)	2,000
		6,000
	Leased plant (80,000 × 20%)	16,000
	Owned plant (154,800 – 34,800) × 20%	24,000
		46,000
3	*Finance cost*	$'000
	Loan note interest (50,000 × 8%)	4,000
	Finance lease (80,000 – 20,000) × 12%	7,200
		11,200
4	*Plant and equipment*	$'000
	Cost: owned plant	154,800
	leased plant	80,000
		234,800
	Depreciation: owned plant (34,800 + 24,000 (W2))	(58,800)
	Leased plant (80,000 × 20%)	(16,000)
		160,000
5	*Retained earnings*	$'000
	Balance b/f	71,600
	Profit for the year	40,200
	Profit on disposal of property (45,000 – 15,000)	30,000
	Dividend paid	(12,000)
		129,800

6	*Leasing obligations*	$'000
	Total payments due	80,000
	Less amount paid	(20,000)
		60,000
	Add accrued interest (60,000 × 12%)	7,200
	Total creditor	67,200
	Due within one year	20,000
	Due after one year	47,200

7	*Trade and other payables*	$'000
	Trial balance	29,400
	Lease creditor (W6)	20,000
	Accrued loan note interest	2,000
		51,400

Companies often used to justify the non-depreciation of buildings on several grounds, including:

(i) That the current value of the buildings was **higher than cost**.

(ii) That the level of **maintenance** meant that no deterioration or consumption had taken place.

(iii) That the depreciation charge would **not be material.**

However, IAS 16 requires the **depreciable amount** of an asset to be charged against profit over its useful life. That depreciable amount is obtained by comparing the cost of the asset with its **estimated residual value** at the end of its useful life. By requiring the residual value to be estimated at **current prices**, the standard removes any **potential inflationary effects** which would otherwise increase the residual value and hence reduce, even to zero, the depreciable amount. This overcomes the argument that high residual values remove the need for depreciation, unless the value of a second-hand asset has greater value than the same asset new – an unlikely proposition.

The argument regarding **immateriality** of the depreciation charge because of a long life may have some validity. Although it is not addressed directly by IAS 16, accounting standards generally only apply to **material items,** according to the *Conceptual Framework.* However, under this principle, it will be necessary to consider not only each year's potential depreciation charge, but also the **accumulated depreciation** that would need to be provided against the asset. Over time, this amount would inevitably become material and the 'long life' argument would cease to hold.

Thus, Winger's **previous policy** was not appropriate and the change to depreciate assets was necessary to comply with IAS 16.

The directors' proposed treatment of the deferred development expenditure is also incorrect. It needs to be written off because its **value** has become **impaired due to adverse legislation, not a change of accounting policy**. It now has no effective value. There has therefore not been a change of accounting policy, so it cannot be treated as a prior period adjustment. It must be written off to profit or loss.

11 Global Konstrukshen

Tutor's hint. Calculate profit or loss on the contract and cost of sales comes out as a balancing figure. You can then work out the accrued cost of sales and accrued future losses.

(a)

	Alpine bypass	*World Ecology centre*
	$'000	$'000
Turnover	2,800	3,000
Profit/(loss) (W)	622	(100)
Cost of sales	2,178	3,100
Current assets		
Amount recoverable on contract (2,800 – 2,600)	200	–
Current liabilities		
Payment on account (3,400 – 3,000)	–	(400)
Accrued cost of sales (2,178 – 1,400)	(778)	–
Accrued future losses (3,100 – 2,900)	–	(200)

(W) Alpine: $(9{,}000 - (1{,}400 + 5{,}600)) \times \frac{2{,}800}{9{,}000} = 622$

World Ecology: $8{,}000 - (2{,}900 + 5{,}200) = 100$

(b) Construction contracts are recognised as such when they cover at **least two accounting periods**. If they were not to be treated as they are under IAS 11 then the costs incurred during the early years of the contract would be recognised but with no corresponding turnover. This would lead to several years of losses then one year of high profits regardless of how profitable the contract really was. The advantage of this approach however would be that there would be no need to use estimates and forecasts.

The current treatment **matches an element of the turnover to the costs incurred**. There is an attempt to maintain **prudence** by ensuring that any **foreseeable** losses are **accounted for immediately**. This gives a fairer representation of the underlying financial substance of the transaction and makes it easier for the user of the accounts to assess the financial position of the company.

12 Provisions

Tutor's hint. A good knowledge of IAS 37 is needed in this question. Do not disregard the discounting aspects, these calculations are quite straightforward as you are given the formulae in the exam.

(a) **Why there was a need for an accounting standard dealing with provisions**

IAS 37 *Provisions, contingent liabilities and contingent assets* was issued to prevent entities from using provisions for creative accounting. It was common for entities to recognise material provisions for items such as future losses, restructuring costs or even expected future expenditure on repairs and maintenance of assets. These could be combined in one large provision (sometimes known as the 'big bath'). Although these provisions reduced profits in the period in which they were recognised (and were often separately disclosed on grounds of materiality), they were then released to enhance profits in subsequent periods. To make matters worse, provisions were often recognised where there was no firm commitment to incur expenditure. For example, an entity might set up a provision for restructuring costs and then withdraw from the plan, leaving the provision available for profit smoothing.

The criteria that need to be satisfied before a provision is recognised

IAS 37 states that a provision should not be recognised unless:

(i) An entity has a present obligation (legal or constructive) as a result of a past event, and

(ii) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and

(iii) A reliable estimate can be made of the amount of the obligation.

An obligation can be legal or constructive. An entity has a constructive obligation if:

(i) It has indicated to other parties that it will accept certain responsibilities (by an established pattern of past practice or published policies), and

(ii) As a result, it has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

(b) Extract should recognise a provision for the estimated costs of making good the site because:

(i) It has a present obligation to incur the expenditure as a result of a past event. In this case the obligating event occurred when it became virtually certain that the legislation would be passed. Therefore the obligation existed at 31 December 20X0, and

(ii) An outflow of resources embodying economic benefits is probable, and

(iii) It is possible to make a reliable estimate of the amount.

Effect on the financial statements

For the year ended 31 December 20X0:

- A provision of \$1,242,000 (2,000,000 × 0.621) is reported as a liability.
- A non-current asset of \$1,242,000 is also recognised. The provision results in a corresponding asset as the expenditure gives the company access to an inflow of resources embodying future economic benefits; there is no effect on profit or loss for the year.

For the year ended 31 December 20X1:

- Depreciation of \$248,400 (1,242,000 × 20%) is charged to profit or loss. The non-current asset is depreciated over its remaining useful economic life of five years from 31 December 20X0 (the site will cease to produce output on 31 December 20X5).
- Therefore at 31 December 20X1 the net book value of the non-current asset will be \$993,600 (1,242,000 – 248,400).
- At 31 December 20X1 the provision will be \$1,366,000 (2,000,000 × 0.683).
- The increase in the provision of \$124,000 (1,366,000 – 1,242,000) is recognised in profit or loss as a finance cost. This arises due to the unwinding of the discount.

13 Jerzy

The defined benefit pension scheme is treated in accordance with IAS 19 *Employee benefits*.

The pension scheme has a deficit of liabilities over assets:

	$m
Fair value of plan assets	200
Present value of obligation	(208)
	(8)

The deficit is reported as a liability in the notes to the statement of financial position.

The notes to the statement of profit or loss and other comprehensive income for the year includes:

	$m
Current service cost	176
Net interest	(16)
	192

IAS 19 requires actuarial gains and losses at the end of the previous accounting period to be recognised within other comprehensive income.

Other comprehensive income for the year would therefore include:

	$m
Actuarial gain on defined benefit pension scheme assets	24

Alternatively, they may be immediately within profit and loss. There were no actuarial gains or losses at the start of the current period. Recognising the gain in this way would provide useful information to users of the financial statements, given that the pension scheme is new and results in a significant additional charge to the statement of profit or loss.

Adjustment to the financial statements:

Dr Retained earnings	$168 million	
Cr Receivables		$160 million
Cr Defined benefit pension scheme liability		$8 million

Working

	$m
Scheme assets:	
Contributions paid	160
Expected return on plan assets	16
Actuarial gain (balancing figure)	24
Fair value of plan assets	200
Scheme liabilities:	
Current service cost	176
Interest cost	32
Present value of obligation	208
Net pension liability	5

14 PQR

(a) **Investment in debentures**

Given that these debentures are planned to be held until redemption, under IFRS 9 *Financial instruments* they would be held at amortised cost, on the assumption that:

(a) The objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

This means that they are initially shown at their cost (including any transaction costs) and their value increased over time to the redemption value by applying a constant effective interest rate which takes into account not only the annual income due from the coupon, but also amortisation of the redemption premium. Their value is reduced by distributions received, ie the coupon.

Consequently the amortised cost valuation of these debentures at the year end would be:

Cost (40,000 – 6,000)	34,000	
Effective interest at 8.6%	2,924	shown as finance income
Coupon received (4% × 40,000)	(1,600)	Debited to cash
	35,324	

The debentures are an asset belonging to the equity holders and so as the increase in value is recognised until redemption, the equity of the business will increase, marginally reducing gearing.

Forward contract

Providing the forward meets the following criteria it qualifies for hedge accounting:

- Designated as a hedge on entering into the contract (including documentation of company's strategy)
- Expected to be 'highly effective' during its whole life (ie gains/losses on the hedging instrument vs losses/gains on the hedged item or *vice versa* fall within the ratio 80% to 125% – this is likely to be the case with a foreign currency forward contract, IAS 39, para AG108)
- The hedge effectiveness can be reliably measured.

  A foreign currency forward contract can be argued to be either a hedge of the future cash flow or a hedge of the fair value of the machine to be purchased. IAS 39 *Financial instruments: recognition and measurement* therefore allows foreign currency hedges of firm commitments to be classed as either a cash flow hedge or a fair value hedge.

  If the contract is classed as a cash flow hedge, given that the machine is not yet recognised in the books, any gain or loss on the hedging instrument is split into two components:

- The effective portion of the hedge (which matches the change in expected cash flow) is recognised initially in other comprehensive income (ie recognised in reserves). It is transferred out of reserves either when the asset is recognised (adjusting the asset base and future depreciation) or when the cash flow is recognised in profit or loss (eg by deprecation) as a reclassification adjustment. Both options therefore apply the accruals concept.
- The ineffective portion of the hedge is recognised in profit or loss immediately as it has not hedged anything.

If the contract is classed as a fair value hedge, all gains and losses on the hedging instrument must be recognised immediately in profit or loss. However, in order to match those against the asset hedged, the gain or loss on the fair value of the asset hedged is also recognised in profit or loss (and as an asset or liability in the statement of financial position). This is arguably less transparent as it results in part of the asset value (the change in fair value) being recognised in the statement of financial position until the purchase actually occurs – consequently, IAS 39 allows the option to treat foreign currency forward contracts as a cash flow hedge.

Gearing will be different depending on whether the forward contract is accounted for as a cash flow hedge or a fair value hedge (and whether a gain or loss on the hedging instrument occurs). Gearing will be less volatile if a fair value hedge is used as the change in fair value of the hedged asset is also recognised offsetting gains or losses on the hedging instrument, whereas this is not the case until the asset is purchased (and recognised) for the cash flow hedge.

Redeemable preference shares

Redeemable preference shares, although called shares, are not, in substance, equity, they are a debt instrument, ie a loan made to the company which receives interest and is paid back at a later date.

Consequently, IAS 32 requires them to be classed as such, ie as a non-current liability in the statement of financial position. The 'dividends' paid will be shown in profit or loss as finance costs and accrued at the end of the year if outstanding, whether declared or not.

The shares are consequently a financial liability held at amortised cost. In this case, given that the shares are issued and redeemed at the same value, the effective interest rate and nominal coupon rate will be the same (6%) and each year $6,000 will be shown as a finance cost in profit or loss and the balance outstanding under non-current liabilities at each year end will be $100,000 as follows:

	$	
Cash received/ b/d value	100,000	
Effective interest at 6%	6,000	shown as finance cost
Coupon paid (6% × 100,000)	(6,000)	credited to cash
	100,000	

In the financial statements for the year ending 31 December 20X7, the shares will need to be reclassified as a current liability given that they will be repaid within one year.

Given that these shares are classed as a financial liability, gearing will be higher (as they are treated as debt) than if they were ordinary shares (which would be treated as equity).

(b) The futures contract was entered into to protect PQR from a fall in oil prices and hedge the value of the inventories. It is therefore a fair value hedge.

The inventories are recorded at their cost of $2,600,000 (100,000 barrels at $26.00) on 1 July 20X5.

The futures contract has a zero value at the date it is entered into and so no entry is made in the financial statements.

> *Tutorial note:* however, the existence of the contract and associated risk would be disclosed from that date in accordance with IFRS 7 (detail outside the scope of the syllabus).

At the year end the inventories must be shown at the lower of cost and net realisable value. Hence they will be shown at $2,250,000 (100,000 barrels at $22.50) and a loss of $350,000 recognised in profit or loss.

However, a gain has been made on the futures contract:

	$
The company has a contract to sell on 31 March 20X6 at $27.50	2,750,000
A contract entered into at the year end would sell at $23.25 on 31 March 20X6	2,325,000
Gain (= the value the contract could be sold on for to a third party)	425,000

The gain on the futures contract is also recognised in profit or loss:

DEBIT	Future contract asset	$425,000
CREDIT	Profit or loss	$425,000

The net effect on profit or loss is a gain of $75,000 ($425,000 less $350,000) whereas without the hedging contract the whole loss of $350,000 would have been the only impact on profit or loss.

Note:

If the inventories had gained in value, this gain would also be recognised in profit or loss as hedge accounting is being applied (normally gains on inventories are not recognised until sale). A loss would have occurred on the futures contract, which would also be recognised in profit or loss.

15 Sirus

> **Tutor's hint**. This question requires you to understand IAS 32, IAS 19, and IRFS 9, so it is a good question with which to test your understanding. Make sure you review this answer carefully against your own and identify any weak areas that you need to work on.

Accounting treatment of items in the financial statements

(a) **Directors' ordinary 'B' shares**

The capital of Sirus must be shown **either as a liability or as equity**. The criteria for distinguishing between financial liabilities and equity are found in IAS 32 *Financial instruments: presentation.* Equity and liabilities must be classified **according to their substance, not just their legal form,**

A **financial liability** is defined as any liability that is:

(i) A contractual obligation:

- To deliver cash or another financial asset to another entity, or
- To exchange financial instruments with another entity under conditions that are potentially unfavourable; or

(ii) A contract that will or may be settled in the entity's own equity instruments.

An **equity instrument** is any contract that evidences a **residual interest** in the assets of an entity after deducting all of its liabilities

The **ordinary 'B' shares,** the capital subscribed by the directors must, according to the directors' service agreements, be returned to any director on leaving the company. There is thus a **contractual obligation** to deliver cash. The redemption **is not discretionary,** and Sirus has no right to avoid it. The mandatory nature of the repayment makes this capital a **liability** (if it were discretionary, it would be equity). On initial recognition, that is when the 'B' shares are purchased, the financial liability must be stated at the **present value of the amount due on redemption,** discounted over the life of the service contract. In subsequent periods, the financial liability may be carried at fair value through profit or loss, or at amortised cost under IFRS 9.

In contrast, the **payment of $3 million** to holders of 'B' shares, is discretionary in that it must be approved in a general meeting by a majority of all shareholders. This approval may be refused, and so it would not be correct to show the $3 million as a liability in the statement of financial position at 30 April 20X8. Instead, it should be recognised when approved. The dividend when recognised will be treated as **interest expense**. This is because IAS 32 (para 35–36) requires the treatment of dividends to follow the treatment of the instrument, ie because the instrument is treated as a liability, the dividends are treated as an expense.

(b) **Directors' retirement benefits**

These are unfunded defined benefit plans, which are likely to be governed by IAS 19 *Employee benefits,* but IAS 32 and IFRS 9 on financial instruments, and IAS 37 *Provisions, contingent liabilities and contingent assets* also apply.

Sirus has contractual or constructive obligations to make payments to former directors. The treatment and applicable standard depends on the obligation.

(i) **Fixed annuity with payment to director's estate on death**. This **meets the definition of a financial liability under IAS 32**, because there is a contractual obligation to deliver cash or a financial asset. The firm does not have the option to withhold the payment. The rights to these annuities are earned over the directors' period of service, so it follows that the costs should also be recognised over this service period.

(ii) **Fixed annuity ceasing on death**

The timing of the death is clearly uncertain, which means that the annuities have a **contingent element** with a mortality risk to be calculated by an actuary. It meets the definition of an insurance contract, which is outside the scope of IFRS 9, as are employers' obligations under IAS 19. However, insofar as there is a constructive obligation, these annuities fall within the scope of IAS 37, because these are liabilities of uncertain timing or amount. The amount of the obligation should be measured in a manner similar to a warranty provision: that is the **probability of the future cash outflow** of the present obligation should be measured for the class of all such obligations. An estimate of the costs should include any liability for post retirement payments that directors have earned so far. The liability should **be built up over the service period** and will in practice be calculated on an actuarial basis as under IAS 19 *Employee benefits.* If the effect is material, the liability will be discounted. It should be **re-calculated every year** to take account of directors joining or leaving, or any other changes.

(c) **Acquisition of Marne**

An increased profit share is payable to the directors of Marne if the purchase offer is accepted. The question arises of whether this additional payment constitutes **remuneration or consideration** for the business acquired. Because the payment is for two years only, after which time remuneration falls back to normal levels, the payment should be seen as part of the **purchase consideration**.

The second issue is the treatment of this consideration. IFRS 3 (revised January 2008) *Business combinations* requires that an acquirer must be identified for all business combinations. In this case Sirus is the acquirer. The cost of the combination must be measured as the sum of the fair values, at the date of exchange, of assets given or liabilities assumed in exchange for control.

IFRS 3 recognises that, by entering into an acquisition, the acquirer becomes obliged to make additional payments. Not recognising that obligation means that the consideration recognised at the acquisition date is not fairly stated.

The revised IFRS 3 **requires recognition of contingent consideration, measured at fair value, at the acquisition date**. This is, arguably, consistent with how other forms of consideration are fair valued.

The acquirer may be required to pay contingent consideration in the form of equity or of a debt instrument or cash. In this case, it is in the form of cash, or increased remuneration.

Accordingly, the **cost of the combination must include the full $11m,** measured at net present value at 1 May 20X7. The payment of $5 million would be discounted for one year and the payment of $6 million for two years.

(d) **Repayment of bank loan**

The bank loan is to be repaid in ten years' time, but the terms of the loan state that Sirus can pay it off in seven years. The issue arises as to **whether the early repayment option is likely to be exercised**.

If, when the loan was taken out on 1 May 20X7 the option **of early repayment was not expected to be exercised, t**hen at 30 April 20X8 the normal terms apply. The loan would be stated at $2 million in the statement of financial position, and the effective interest would be 8% × $2 million = $160,000, the interest paid.

If at 1 May 20X7 it was expected that the **early repayment option would be exercised**, then the **effective interest rate would be 9.1%,** and the effective interest 9.1% × $2 million = $182,000. The cash paid would still be $160,000, and the difference of $22,000 would be added to the carrying amount of the financial liability in the statement of financial position, giving $2,022,000.

IFRS 9 *Financial instruments* requires that the carrying amount of a financial asset or liability should be adjusted to reflect actual cash flows or revised estimates of cash flows. This means that, even if it was thought at the outset that early repayment would not take place, if **expectations then change**, **the carrying amount must be revised** to reflect future estimated cash flows using the effective interest rate.

The directors of Sirus are currently in discussion with the bank regarding repayment in the next financial year. However, these discussions do not create a legal obligation to repay the loan in twelve months, and Sirus has an unconditional right to defer settlement for longer than twelve months. Accordingly, **it would not be correct to show the loan as a current liability on the basis of the discussions with the bank**.

16 DT Group

(a) **Calculation of deferred tax liability**

			Carrying amount $m	*Tax base* $m	*Temporary differences* $m
Goodwill (note 1)			14	–	–
Subsidiary (note 1)			76	60	16
Inventories (note 2)			24	30	(6)
Property, plant and equipment (note 3)			2,600	1,920	680
Other temporary differences					90
Liability for health care benefits			(100)	0	(100)
Unrelieved tax losses (note 4)					(100)
Property sold – tax due 30.11.20X4 (165/30%)					550
Temporary differences					1,130
Deferred tax liability (680 + 90 + 550)	1,320	at 30%			396
Deferred tax liability	16	at 25%			4
Deferred tax asset	(200)	at 30%			(60)
Deferred tax asset	(6)	at 25%			(1.5)
	1,130				338.5

Deferred tax liability b/d (given)	280
Deferred tax attributable to subsidiary to goodwill (76 – 60) × 25%	4
∴ Deferred tax expense for the year charged to P/L (balance)	54.5
Deferred tax liability c/d (from above)	338.5

Notes:

1 As no deduction is available for the cost of goodwill in the subsidiary's tax jurisdiction, then the tax base of goodwill is zero. Paragraph 15(a) of IAS 12, states that DT Group should not recognise a deferred tax liability of the temporary difference associated in B's jurisdiction with the goodwill. Goodwill will be increased by the amount of the deferred tax liability of the subsidiary ie $4 million.

2 Unrealised group profit eliminated on consolidation are provided for at the receiving company's rate of tax (ie at 25%).

3 The tax that would arise if the properties were disposed of at their revalued amounts which was provided at the beginning of the year will be included in the temporary difference arising on the property, plant and equipment at 30 November 20X1.

4 DT Group has unrelieved tax losses of $300m. This will be available for offset against current year's profits ($110m) and against profits for the year ending 30 November 20X2 ($100m). Because of the uncertainty about the availability of taxable profits in 20X3, no deferred tax asset can be recognised for any losses which may be offset against this amount. Therefore, a deferred tax asset may be recognised for the losses to be offset against taxable profits in 20X2. That is $100m × 30% ie $30m.

(b) **Report**

To: The Directors, DT Group
From: Accountant
Date: XX.XX.XX

Effect of application of IAS 12 on financial statements

The application of IAS 12will have the following effect on the financial statements of the DT group: The deferred tax liability of DT Group will rise in total by $335.5 million ($338.5m – $3m), thus reducing net assets, distributable profits, and post-tax earnings.

The profit for the year will be reduced by $54.5 million which would probably be substantially more under IAS 12 than the old method of accounting for deferred tax.

A prior period adjustment will occur of $280m – $3m as IAS are being applied for the first time (IFRS 1) ie $277m.

The borrowing position of the company may be affected and the directors may decide to cut dividend payments.

However, the amount of any unprovided deferred tax may have been disclosed under the previous GAAP standard used.

IAS 12 brings this liability into the statement of financial position but if the bulk of the liability had already been disclosed the impact on the share price should be minimal.

I hope that this report is helpful to you.

Signed, Accountant

17 Courtney

(a) Courtney must recognise the purchase of goods at the exchange rate in place at the date of the transaction.

Therefore:

300,000 Wons/20 = $15,000

DR	Purchases	$15,000	
CR	Trade payables		$15,000

At the year end, the supplier has not been paid, so the liability is still outstanding. It must be translated at the closing rate at the year end and any exchange gains or losses recognised in the statement of profit or loss.

The liability at 31 December 20X7 is:

3000,000 Wons/16 = $18,750

It has increased and Courtney must recognise an exchange loss of $3,750 (18,750 – 15,000).

DR	Statement of profit or loss	$3,750	
CR	Trade payables		$3,750

(b) Functional currency is the currency of the primary economic environment in which the entity operates. Determining an entity's functional currency involves looking at the currency that influences sales prices and costs. Additionally, if an entity raises finance in its home currency, that is likely to be its functional currency.

In Courtney's case, it operates in US$, which is the functional currency.

The presentation currency is the currency in which the financial statements are presented. Courtney may well prepare financial statements in their functional currency (US$), but the parent company reports in Euros, so Courtney's results will have to be translated into Euros so that they can be consolidated. The group presentation currency is the Euro.

18 Farmer Gyles

(a) A **biological asset** is a **living animal** or **plant** whereas **agricultural produce** is the **harvested produce** of an entity's biological assets. Harvest, in turn, is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

(b) Asset changes

(i) **Growth**: increase in quality and/or quality
(ii) **Degeneration**: decrease in quantity and/or quality

Creation of new assets

(i) **Production**: producing saleable non-living products
(ii) **Procreation**: producing separate living animals

(c) IAS 41 requires that at each reporting date, all **biological assets** should be measured **at fair value less estimated point-of-sale costs**.

If at **initial recognition**, **fair value cannot be determined** because market determined prices or values are not available, they may be valued at **cost less accumulated depreciation and impairment losses**.

(d) **Agricultural produce**. It is **recognised at the point of harvest** (eg detachment from biological asset). Agricultural produce is either incapable of biological process or such processes remain dormant (eg stored grain). **Recognition ends** once the produce enters trading activities or production processes within integrated agribusinesses, although processing activities that are incidental to agricultural activities and that do not materially alter the form of the produce (eg drying or cleaning) are not counted as processing. Following harvest, the provisions of IAS 2 apply.

19 Vident

(a) **Why share based payments should be recognised in the financial statements**

IFRS 2 *Share based payment* applies to **all share option schemes granted after 7 November 2002**. The directors have put forward several arguments for not recognising the expense of remunerating directors in this way.

Share options have no cost to the company

When shares are **issued for cash** or in a business acquisition, **an accounting entry is needed** to **recognise the receipt of cash** (or other resources) as consideration for the issue. Share options (the right to receive shares in future) **are also issued in consideration for resources**: services rendered by directors or employees. These resources are **consumed by the company** and it would be **inconsistent not to recognise an expense**.

Share issues do not meet the definition of an expense in the IASB Conceptual Framework

The *Framework* defines an expense as a **decrease in economic benefits** in the form of **outflows of assets** or **incurrences of liabilities**. It is not immediately obvious that employee services meet the definition of an asset and therefore **it can be argued that consumption of those services does not meet the definition of an expense**. However, share options **are issued for consideration in the form of employee services** so that **arguably there is an asset**, although it is **consumed at the same time that it is received**. Therefore the recognition of an expense relating to share based payment is **consistent with the *Conceptual Framework***.

The expense relating to share options is already recognised in the diluted earnings per share calculation

It can be argued that to recognise an expense in profit or loss **would have the effect of distorting diluted earnings per share** as diluted earnings per share would then **take the expense into account twice**. This is not a valid argument. There are **two events** involved: **issuing the options**; and **consuming the resources** (the directors' services) received as consideration. The diluted

earnings per share calculation **only reflects the issue of the options**; there is **no adjustment to basic earnings**. Recognising an expense reflects the consumption of services. There is **no 'double counting'**.

Accounting for share based payment may discourage the company from introducing new share option plans

This is quite **possibly true**. Accounting for share based payment **reduces earnings**. However, it **improves the information provided** in the financial statements, as these now make users aware of the **true economic consequences** of issuing share options as remuneration. The economic consequences are the reason why share option schemes may be discontinued. IFRS 2 simply **enables management and shareholders** to **reach an informed decision** on the best method of remuneration.

(b) **Accounting for share options in the financial statements for the year ended 31 May 20X5**

The basic principle of accounting for share options is that **an expense is recognised** for the **services rendered** by the directors and a **corresponding amount is credited to equity**. The transaction is **measured at the fair value of the options granted at the grant date** and fair value is taken to be the **market price**. Where (as is usual) options vest only after staff have completed a specified period of service, the expense is **allocated to accounting periods over this period of service.**

Options granted to J. Van Heflin on 1 June 20X3

The **performance conditions have been met** and the director is **still working for the company** at 31 May 20X5. As the **number of shares** that will vest is **fixed**, the expense is **allocated on a straight line basis to the two years ended 31 May 20X5**.

Options granted to R. Ashworth on 1 June 20X4

The **performance conditions** (the increase in the share price to $13.50) **have not yet been met**. However, such 'market conditions' need not be considered as they are already factored into the fair value of the share options. In terms of the period of service condition, the director is **still working for the company** and **must work for the company for three years** before the options vest, so the **expense is recognised**. Again, the **number of shares is fixed**, so the expense is **allocated on a straight line basis over the three years to 31 May 20X7**. The expense to be recognised is calculated as follows:

	At 1 June 20X4	*Year ended 31 May 20X5*
	$	$
J. Van Heflin (20,000 × $5 × ½)	50,000	50,000
R. Ashworth (50,000 × $6 × 1/3)		100,000
	50,000	150,000

At 1 June 20X4 the **opening balance of retained earnings is reduced by $50,000** and a **separate component of equity is increased by $50,000**.

An **expense of $150,000 is recognised** in profit or loss for the year ended 31 May 20X5. **Equity** (the same separate component as before) is **credited with $150,000**.

(c) **Deferred tax implications of the recognition of an expense for directors' share options**

The company will **recognise an expense** for the consumption of employee services given in consideration for share options granted, **but will not receive a tax deduction until the share options are actually exercised**. Therefore a **temporary difference arises** and IAS 12 *Income taxes* requires the recognition of deferred tax.

A **deferred tax asset** (a deductible temporary difference) results from the **difference** between the **tax base of the services received** (a tax deduction in future periods) and the **carrying value of zero**. IAS 12 requires the **measurement** of the deductible temporary difference to be based on the **intrinsic value of the options at the year end**. This is the **difference** between the **fair value of the share** and the **exercise price of the option**.

If the amount of the **estimated future tax deduction exceeds the amount of the related cumulative remuneration expense**, the tax deduction relates not only to the remuneration expense, but to equity. If this is the case, the **excess should be recognised directly in equity**.

At 1 June 20X4

Deferred tax asset:

	$
Fair value (20,000 × $12.50 × 1/2)	125,000
Exercise price of option (20,000 × $4.50 × ½)	(45,000)
Intrinsic value (estimated tax deduction)	80,000
Tax at 30%	24,000

The cumulative remuneration expense is $50,000, which is less than the estimated tax deduction. Therefore:

- A deferred tax asset of $24,000 is recognised in the opening statement of financial position.
- Opening retained earnings are increased by $15,000 (50,000 × 30%).
- The excess of $9,000 (30,000 × 30%) goes to equity.

The comparative is re-stated for the options granted on 1 June 20X3.

Year to 31 May 20X5

Deferred tax asset:

	$
Fair value:	
(20,000 × $12)	240,000
(50,000 × $12 × 1/3)	200,000
	440,000
Exercise price of options	
(20,000 × $4.50)	(90,000)
(50,000 × $6 × 1/3)	(100,000)
Intrinsic value (estimated tax deduction)	250,000
Tax at 30%	75,000
Less previously recognised	(24,000)
	51,000

The cumulative remuneration expense is $200,000, which is less than the estimated tax deduction. Therefore:

- A deferred tax asset of $75,000 is recognised in the statement of financial position at 31 May 20X5.
- There is potential deferred tax income of $51,000 for the year ended 31 May 20X5.
- Of this, $6,000 (50,000 × 30% – 9,000) goes directly to equity.
- The remainder ($45,000) is recognised in profit or loss for the year.

20 Polymer

Tutor's hint. Redeemable preference shares are presented under IAS 32 Financial Instruments: Presentation as a loan payable, and dividends on them as interest payable.

(a) **POLYMER CO: STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 MAY 20X8**

	$
Revenue	1,526,750
Cost of sales (W3)	(1,048,000)
Gross profit	478,750
Distribution costs (W4)	(124,300)
Administrative expenses (W5)	(216,200)
Finance costs (W6)	(18,400)
Profit before tax	119,850
Income tax expense	(40,000)
PROFIT FOR THE YEAR	79,850

POLYMER CO: STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20X8

	$
ASSETS	
Non-current assets	
Property, plant and equipment (W7)	452,250
Intangible assets	215,500
	667,750
Current assets	
Inventories (W8)	425,750
Receivables (W9)	171,880
Cash and cash equivalents	5,120
	602,750
Total assets	1,270,500
EQUITY AND LIABILITIES	
Equity	
Share capital	300,000
Share premium reserve	100,000
Retained earnings (283,500 + 79,850)	363,350
General reserve	50,000
Revaluation surplus	50,000
	863,350
Non-current liabilities	
10% debentures	100,000
8.4% cumulative redeemable preference shares*	100,000
	200,000
Current liabilities	
Trade and other payables (W10)	115,900
Short-term borrowings	51,250
Current tax payable	40,000
	207,150
Total equity and liabilities	1,270,500

Workings

1 *Depreciation*

Cost of sales:	8% × 150,000	12,000
Administration:	10% × 50,000	5,000
	1/4 × 20% × 50,000	2,500
		7,500
Distribution:	3/4 × 20% × 50,000	7,500

2 *Depreciation (amortisation) of lease*

$75,000 × 1/50	1,500

3 *Cost of sales*

	$
Opening inventories (108,400 + 32,750 + 184,500)	325,650
Purchases	750,600
Carriage inwards	10,500
Manufacturing wages	250,000
Manufacturing overheads	125,000
Depreciation of plant (W1)	12,000
Closing inventories (W9)	(425,750)
	1,048,000

4 *Distribution costs*

	$
Per question	116,800
Depreciation (W1)	7,500
	124,300

5 *Administrative expenses*

Per question		158,100
Legal expenses	54,100	
less: solicitors' fees capitalised	(5,000)	
		49,100
Depreciation (W1)		7,500
Amortisation of lease (W2)		1,500
		216,200

6 *Finance costs*

	$
Interest expense on loan notes ($100,000 × 10%)	10,000
Dividend on redeemable preference shares ($100,000 × 8.4%)	8,400
	18,400

7 *Property, plant and equipment*

	Freehold land	*Leasehold property*	*Plant & equipment*	*Furniture & fixtures*	*Motor vehicles*	*Total*
	$	$	$	$	$	$
NBV per TB						
Cost or valuation	250,000	75,000	150,000	50,000	75,000	
Accumulated dep'n	–	(15,000)	(68,500)	(15,750)	(25,000)	
Net book value	250,000	60,000	81,500	34,250	50,000	
Solicitor's fees	5,000					
Depreciation charge	–	(1,500)	(12,000)	(5,000)	(10,000)	
NBV 31 May 20X8	255,000	58,500	69,500	29,250	40,000	452,250

8 *Inventories*

	$
Raw materials	112,600
Work in progress	37,800
Finished goods	275,350
	425,750

9 *Receivables*

	$
Trade receivables (177,630 – 5,750 allowance for receivables)	171,880

10 *Trade and other payables*

	$
Trade payables	97,500
Loan interest payable	10,000
Preference dividend payable	8,400
	115,900

(b) The stated **purposes** of the *Conceptual Framework* are as follows.

(i) To assist the Board in the development of future IFRSs and in its review of existing IFRSs.

(ii) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures by reducing the number of alternative accounting treatment permitted by IFRSs.

(iii) To assist national standard-setting bodies in developing national standards.

(iv) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.

(v) To assist auditors in forming an opinion on whether financial statements comply with IFRSs.

(vi) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs.

(vii) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

One of the ideas behind the *Conceptual Framework* is to **avoid the fire-fighting approach**, which has characterised the development of accounting standards in the past, and instead develop an underlying philosophy as a basis for consistent accounting principles so that each standard fits into the whole framework. Research began from an analysis of the fundamental objectives of accounting and their relationship to the information needs of accounts users. The *Conceptual Framework* has gone behind the requirements of existing accounting standards, which define accounting treatments for particular assets, liabilities, income and expenditure, to define the nature of assets, liabilities, income and expenditure.

(c) The **going concern assumption** is that an entity will continue in operational existence for the foreseeable future. This means that the financial statements of an entity are prepared on the assumption that the entity will **continue** trading. If this were not the case, various adjustments would have to be made to the accounts: provisions for losses; revaluation of assets to their possible market value; all non-current assets and liabilities would be reclassified as current; and so forth.

Unless it can be assumed that the business is a going concern, other accounting assumptions cannot apply.

For example, it is meaningless to speak of consistency from one accounting period to the next when this is the final accounting period.

The **accruals basis** of accounting states that items are recognised as assets, liabilities, equity, income and expenses when they satisfy the definitions and recognition criteria in the *Conceptual Framework.* The effect of this is that revenue and expenses which are related to each other are matched, so as to be dealt with in the same accounting period, without regard to when the cash is

actually paid or received. This is particularly relevant to the purchase of non-current assets. The cost of a non-current asset is spread over the accounting periods expected to benefit from it, thus matching costs and revenues. In the absence of the going concern convention, this cannot happen, as an example will illustrate.

Suppose a company has a machine which cost $10,000 two years ago and now has a carrying amount of $6,000. The machine can be used for another three years, but as it is highly specialised, there is no possibility of selling it, and so it has no market value.

If the going concern assumption applies, the machine will be shown at **cost less depreciation** in the accounts (ie $6,000), as it still has a part to play in the continued life of the entity. However, if the assumption cannot be applied, the machine will be given a nil value and other assets and liabilities will be similarly revalued on the basis of winding down the company's operations.

21 Hewlett

(a)

HEWLETT
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'m
Revenue	2,648
Cost of sales (W1)	(1,765)
Gross profit	883
Distribution costs (W1)	(514)
Administrative expenses (W1)	(360)
Finance costs (150 × 4%)	(6)
Fair value gain on investment properties (588 – 548)	40
Rental income	48
Profit before tax	91
Income tax expense (note vi) (45 – 17)	(28)
PROFIT FOR THE YEAR	63
Other comprehensive income:	
Gain on property revaluation (W2)	55
Income tax relating to gain on property revaluation	(17)
Other comprehensive income, net of tax	38
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	101

HEWLETT
STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

	$'m
ASSETS	
Non-current assets	
Property, plant and equipment (W2)	852
Investment properties (note ix)	588
	1,440
Current assets	
Inventories (388 – (21 – 14))	381
Trade receivables	541
Cash and cash equivalents	32
	954
	2,394

EQUITY AND LIABILITIES

	$'m
Equity	
Share capital	125
Share premium	244
Retained earnings	810
General reserve	545
Revaluation surplus ((W2) 55 – 17)	38
	1,762
Non-current liabilities	
4% loan notes 20X8	150
Current liabilities	
Trade payables	434
Income tax payable (note vi)	45
Interest payable ((4% × 150) – 3)	3
	482
	2,394

HEWLETT
STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X2

	Share capital	Share premium	Retained earnings	General reserve	Revaluation surplus	Total
	$'m	$'m	$'m	$'m	$'m	$'m
Balance at 1 January 20X2	100	244	753	570		1,667
Changes in equity for 20X2						
Issue of share capital (W4)	25			(25)		–
Dividends (W5)			(6)			(6)
Total comprehensive income for the year			63		38	101
Balance at 31 December 20X2	125	244	810	545	38	1,762

Workings

1 *Expenses*

	Cost of sales	Distribution	Admin
	$'m	$'m	$'m
Per TB	1,669	514	345
Opening inventories	444		
Depreciation of buildings (W2)			15
Depreciation of plant and equipment (W2)	24		
Impairment loss on plant (W3)	4		
Loss on sale of equipment ((15 – 3) – 7)	5		
Closing inventories (388 – (21 – 14))	(381)		
	1,765	514	360

2 *Property, plant and equipment*

	Land	*Buildings*	*Plant & equipment*	*Total*
	$'m	$'m	$'m	$'m
Cost	90	750	258	
Accumulated depreciation b/d	–	(120)	(126)	
NBV b/d at 1 January 20X2	90	630	132	
Disposal of equipment (15 – 3)			(12)	
	90	630	120	

Depreciation during year				
Buildings ($750m/50 years)		(15)		
Plant & equipment ($120m × 20%)			(24)	
Impairment loss on plant (W3)			(4)	
	90	615	92	
Revaluation (balancing figure)	10	45		55
NBV c/d at 31 December 20X2 (Buildings 760 – 100)	100	660	92	852

3 *Impairment loss on plant*

	$'m
Carrying value	22
Recoverable amount (Value in use: (3.8m × 3.993) + (4.2m × 0.677))	(18)
	(4)

Recoverable amount is the higher of value in use ($18m) and fair value less costs of disposal ($16m).

4 *Bonus issue*

Dr General reserve ($100m /$0.50 × 1/4 = 50m shares × $0.50)	$25m
Cr Share capital	$25m

5 *Dividends (proof)*

	$'m
Interim ($100m /$0.50 = 200m shares × $0.03)	6 per trial balance

The final dividend has not been paid and is not a liability of the company at the year end.

(b) **Accounting entries**

		$	$
31.12.X3			
DEBIT	Profit or loss (Staff costs)	352,500	
CREDIT	Equity reserve ((800 – 95) × 200 × $7.50 × 1/3)		352,500
31.12.X5			
DEBIT	Profit or loss (Staff costs) (W1)	377,500	
CREDIT	Equity reserve		377,500
31.12.X3			
DEBIT	Profit or loss (Staff costs) (W2)	380,000	
CREDIT	Equity reserve		380,000
Issue of shares:			
DEBIT	Cash (740 × 200 × $1.50)	222,000	
DEBIT	Equity reserve	1,110,000	
CREDIT	Share capital (740 × 200 × $1)		148,000
CREDIT	Share premium (balancing figure)		962,000

Workings

1 *Equity reserve at 31.12.X4*

	$
Equity b/d	352,500
∴ P/L charge	377,500
Equity c/d ((800 – 70) × 200 × $7.50 × 2/3)	730,000

2 *Equity reserve at 31.12.X5*

Equity b/d	730,000
∴ P/L charge	380,000
Equity c/d ((800 – 40 – 20) × 200 × \$7.50 × 3/3)	1,110,000

(c) **Cash-settled share-based payment**

If J&B had offered cash payments based on the value of the shares at vesting date rather than options, in each of the three years an accrual would be shown in the statement of financial position representing the expected amount payable based on the following:

No of employees estimated at the year end to be entitled to rights at the vesting date	×	Number of rights each	×	Fair value of each right at year end	×	Cumulative proportion of vesting period elapsed

The movement in the accrual would be charged to profit or loss representing further entitlements received during the year and adjustments to expectations accrued in previous years.

The accrual would continue to be adjusted (resulting in a profit or loss charge) for changes in the fair value of the right over the period between when the rights become fully vested and are subsequently exercised. It would then be reduced for cash payments as the rights are exercised.

22 Halliday Inns

(a)

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X0

	\$'000
Turnover	68,500
Cost of sales (W2)	(25,980)
Gross profit	42,520
Distribution costs	(4,000)
Administrative expenses (W3)	(9,000)
Operating profit	29,520
Interest	(4,950)
Profit before tax	24,570
Taxation (10,200 + 50) (W5)	(10,250)
	14,320

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X0

	\$'000	\$'000
Assets		
Tangible non-current assets (W4)		440,450
Current assets		
Inventory	470	
Cash at bank	300	
	770	
Payables: amount due within one year		
Trade payables	1,700	
Taxation	10,200	
	11,900	
Net current liabilities		(11,130)
		429,320
Payables: amount due after one year		
Loans		(110,000)
		319,320

Capital and reserves		
Share capital		220,000
Reserves	93,320	
Proposed dividend	6,000	
		99,320
		319,320

Workings

1 *Depreciation*

	$'000
Hotels 490,000 @ 2%	9,800
Fixtures and fittings (18,000 – 9,400) @ 25%	2,150
	11,950

2 *Cost of sales*

	$'000
Food purchases	2,100
Heating and lighting	3,000
Housekeeping and restaurant staff	9,000
Opening inventory	400
Closing inventory	(470)
Depreciation	11,950
	25,980

3 *Administrative expenses*

	$'000
Administration	3,000
Staff wages	6,000
	9,000

4 *Tangible non-current assets*

	Hotels	*Fixtures and fittings*	*Total*
	$'000	$'000	$'000
Cost or valuation			
As at 1 January 20X0	478,000	11,000	489,000
Additions	12,000	7,000	19,000
As at 31 December 20X0	490,000	18,000	508,000
Depreciation			
As at 1 January 20X0	46,200	9,400	55,600
Charge for the year	9,800	2,150	11,950
As at 31 December 20X0	56,000	11,550	67,550
Net book value as at 31 December 20X0	434,000	6,450	440,450
Net book value as at 1 January 20X0	431,800	1,600	433,400

5 *Taxation*

	$'000
Taxation charge for the year	10,200
Under provision from the previous year	50
	10,250

(b) The lease appears to be a finance lease for the following reasons:

- the present value of minimum lease payments amounts to 98% ($84,000/$86,000) of the fair value of the asset at inception of the lease, which can be regarded as 'substantially all'.
- the asset will be used by Halliday Inns' for the whole of its useful life, as it will be scrapped by the lessor at the end of the lease.

Consequently the asset should be capitalised in the statement of financial position. The asset should be depreciated over the shorter of its useful life (five years) and the lease term (six years).

A lease liability will be shown in the statement of financial position reduced by lease payments made in advance and increased by interest calculated using the interest rate implicit in the lease, 12.5%.

Both the asset and lease liability will initially be recognised at $84,000, the present value of minimum lease payments, as this is lower than the fair value of the asset. In present value terms the lessor is making a $2,000 loss by not selling the asset at its market value of $86,000, but may have reasons for doing so or the market may be illiquid.

FINANCIAL STATEMENT EXTRACTS

	$
Statement of profit or loss (extract)	
Depreciation (W1)	16,800
Finance costs (W2)	8,198
Statement of financial position (extract)	
Non-current assets	
Leasehold assets (W1)	67,200
Non-current liabilities	
Finance lease liability (W2)	55,358
Current liabilities	
Finance lease liability (W2) (73,778 – 55,358)	18,420

Workings

1 *Carrying amount of leased asset*

	$
Depreciation of asset: $84,000/5 years useful life	16,800
Carrying amount at year end ($84,000 – $16,800)	67,200

The asset is depreciated over the shorter of its useful life (five years) and lease term (six years).

2 *Finance lease*

		$
1.1.X1	Present value of minimum lease payments	84,000
1.1.X1	Payment in advance	(18,420)
		65,580
1.1.X1 – 31.12.X1	Interest at 12.5% ($65,580 × 12.5%)	8,198
31.12.X1	**Finance lease liability c/d**	**73,778**
1.1.X2	Payment in advance	(18,420)
1.1.X2	**Finance lease liability c/d after next instalment**	**55,358**

The interest element ($8,198) of the current liability can also be shown separately as interest payable.

23 Cher

Tutor's hint. The calculations involved in this question are not particularly complicated. However, a large number of marks are available for explanations and understanding. Part (c), particularly requires you to think very carefully about the implications of the uniting of interests method for EPS.

(a) CHER INC

EARNINGS PER SHARE FOR THE YEAR ENDED 30 JUNE 20X4

Earnings		$460,000
Number of shares		
In issue for full year		800,000
In issue 1.7.X3 – 30.9.X3		
$200,000 \times {}^3/_{12} \times 60\%$	30,000	
In issue 1.10.X3 – 30.6.X4		
$200,000 \times {}^9/_{12} \times 100\%$	150,000	
		180,000
		980,000

$$\text{Earnings per share} = \frac{460,000}{980,000} = 46.9c$$

(b) (i) Theoretical ex rights price per share

	$
Value of 4 shares before rights issue (4 × 1.90)	7.60
Value of 1 rights issue share	1.30
Value of 5 shares after rights issue	8.90

$$\text{Theoretical ex rights price } \frac{8.90}{5} = \$1.78$$

Earnings		$1,310,000
Number of shares in issue		
1.7.X4 – 28.2.X5		
$1,000,000 \times \frac{8}{12} \times \frac{1.90}{1.78}$	711,610	
1.3.X5 – 30.6.X5		
$1,250,000 \times {}^4/_{12}$	416,667	
		1,128,277

$$\text{EPS } \frac{1,310,000}{1,128,277} = 116.1c$$

Revised EPS calculation for 20X4

$$46.9c \times \frac{1.78}{1.90} = 43.9c$$

20X5	*20X4*
116.1c	43.9c

(ii)

> **Tutor's hint.** The main point to get across is that a rights issue is like a bonus issue combined with an issue at full market price

A rights issue is a popular method through which public companies are able to access the stock market for further capital. Under the terms of such an issue, existing shareholders are given the opportunity to acquire further shares in the company on a pro-rata basis to their existing shareholdings.

The 'rights' shares will usually be offered at a discount to the market price. In such cases, the issue is equivalent to a bonus issue combined with an issue at full market price. Bonus issues are treated as though they have been in issue for the whole year and are also taken into account in the previous year's EPS calculation to give a comparable result.

The bonus element of the rights issue is given by the following fraction, sometimes referred to as the *bonus fraction*.

$$\frac{\text{Actual cum rights price on last day of quotation cum rights}}{\text{Theoretical ex rights price}}$$

The 'cum rights price' is the *actual* price at which the shares are quoted inclusive of the right to take up the future shares under the rights issue.

The 'ex rights price' is the *theoretical* price at which the shares would be quoted, other stock market factors apart, after the rights issue shares have been issued.

In order to calculate earnings per share with a rights issue, the shares are time apportioned before and after the date of the rights issue. The number of shares is calculated in two stages as follows.

Before rights issue

Number of shares × Bonus fraction × Fraction of year
before rights issue before rights issue

After rights issue

Number of shares after rights issue × Fraction of year after rights issue

The two figures produced by the above calculations are added together to give the denominator for the fraction required in calculating earnings per share.

When calculating the revised earnings per share for the previous year, the latter has to be adjusted to take account of the bonus element by multiplying it by the following

$$\frac{\text{Theoretical ex rights price}}{\text{Actual cum rights}}$$

This makes the previous year's figure comparable with that of the current year.

(c) *Current year*

Earnings		$1,520,000
Number of shares		
As at 1 July 20X5 (the new share capital after the rights issue)	1,250,000	
2 Sonny for 1 Cher	× 2	2,500,000

$$\text{EPS} = \frac{1,520,000}{2,500,000} = 60.8\text{c}$$

Tutor's hint. We are told in the question that the principles of the uniting of interests method have been adopted. This means that the shares in issue at the end of the year are assumed to have been in issue for the whole of the year. There is therefore no need to time apportion as we had to with the rights issue. The previous year's EPS figure will have to be adjusted to reflect the number of shares deemed to have been in issue in that year, ie twice as many as were in fact in issue.

Previous year
EPS = 116.1p × ½ = 58.05c

SONNY INC
EARNINGS PER SHARE FOR THE YEAR ENDED 30 JUNE

	20X6	*20X5*
	60.8c	58.05c

24 Engina

Related Party Transactions

Disclosure of related party transactions may be regarded as politically and culturally sensitive. However, there are **sound reasons for the required disclosures**. It should be emphasised that related party transactions are a normal part of business life, and the disclosures are required to give a fuller picture to the users of accounts, rather than because they are problematic.

Prior to the issue of IAS 24, disclosures in respect of related parties were concerned with directors and their relationship with the group. The **IASB extends this definition and also the required disclosures**. This reflects the objective of the IASB to provide **useful data for investors**, not merely for companies to report on stewardship activities.

Unless investors know that transactions with related parties have not been carried out at **'arm's length'** between independent parties, they may fail to ascertain the **true financial position**.

Related party transactions typically take place on **terms which are significantly different** from those undertaken on normal commercial terms.

IAS 24 requires all material related party transactions to be disclosed.

It should be noted that related party transactions are not necessarily fraudulent or intended to deceive. Without proper disclosures, investors may be disadvantaged – IAS 24 seeks to remedy this.

Sale of goods to the director

(a) **Disclosure** of related party transactions is only necessary when the transactions are material. For the purposes of IAS 24, however, transactions are material when their disclosure might reasonably be **expected to influence decisions made by users of the financial statements, irrespective of their amount**.

(b) The **materiality** of a related party transaction with an individual, for example a director, must be **judged by reference to that individual** and not just the company. In addition, **disclosure of contracts** of **significance** with **directors** is required by most **Stock Exchanges**.

(c) Mr Satay has purchased $600,000 (12 × $50,000) worth of goods from the company and a car for $45,000, which is just over half its market value.

(d) The transactions are not material to the company, and because Mr Satay has considerable personal wealth, they are not material to him either.

(e) However, IAS 24 confirms that directors are related parties and transactions with directors should be disclosed. In addition, IAS 24 requires disclosure of **compensation** paid to directors. Compensation includes subsidised goods and benefits in kind. **Details of the transaction should be disclosed**, including the amount of the transactions and any outstanding balances.

Hotel property

(a) The hotel property sold to the Managing Director's brother is a **related party transaction**, and it appears to have been undertaken at **below market price**.

(b) IAS 24 envisages disclosure of the substance of the transaction.

(c) IAS 24 requires disclosure of 'information about the **transaction** and **outstanding balances** necessary for an understanding of the **potential effect of the relationship upon the financial statements**'.

(d) Not only must the transaction itself be disclosed, but the question of **impairment** needs to be **considered**. The value of the hotel has become impaired due to the **fall in property prices**, so the **carrying value needs to be adjusted** in accordance with IAS 36 *Impairment of assets*. The hotel should be shown at the lower of carrying value ($5m) and the recoverable amount. The recoverable amount is the higher of fair value less costs of disposal ($4.3m – $0.2m = $4.1m) and value in use ($3.6m). Therefore the hotel should be shown at $4.1m.

The sale of the property was for $100,000 below this impaired value, and it is this amount which needs to be disclosed. This would highlight the nature of the transactions within the existing property market conditions.

Group structure

(a) Local companies legislation and the Stock Exchange often require **disclosure of directors' interests** in a company's share capital. IAS 24 requires disclosure of the 'ultimate controlling party'. Mr Satay controls Engina as a result of his ownership of 80% of the share capital of Wheel.

(b) IAS 24 requires disclosure of the **related party relationship** between Engina and Wheel and also of **transactions** between the two companies, despite the fact that Engina is a wholly owned subsidiary.

(c) Engina's transactions with Car Ltd will also need to be disclosed. IAS 24 states that companies under **common control** are related parties, and the two companies are under the common control of Mr Satay.

25 Group Accounts

Tutor's hint. This is a general question to get you thinking about the nature of a group. The question strongly hints that there *are* limitations to group accounts.

The object of annual accounts is to help shareholders exercise control over their company by providing information about how its affairs have been conducted. The shareholders of a holding company would not be given sufficient information from the accounts of the holding company on its own, because not enough would be known about the nature of the assets, income and profits of all the subsidiary companies in which the holding company has invested. The primary purpose of group accounts is to provide a true and fair view of the position and earnings of the holding company group as a whole, from the standpoint of the shareholders in the holding company.

A number of arguments have been put forward, however, which argue that group accounts have certain limitations.

(a) Group accounts may be misleading.

  (i) The solvency (liquidity) of one company may hide the insolvency of another.
  (ii) The profit of one company may conceal the losses of another.
  (iii) They imply that group companies will meet each others' debts (this is certainly not true: a parent company may watch payables of an insolvent subsidiary go unpaid without having to step in).

(b) There may be some difficulties in defining the group or 'entity' of companies, although company law and accounting standards have removed many of the grey areas here.

(c) Where a group consists of widely diverse companies in different lines of business, a set of group accounts may obscure much important detail unless supplementary information about each part of the group's business is provided.

26 Small and medium-sized entities

Tutor's hint. In part (a), for the sake of completeness more advantages and disadvantages are given than would be expected in an exam for the marks on offer.

(a) **Advantages**

Although International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) were originally designed to be suitable for all types of entity, in recent years IFRSs have come increasingly complex. They are now designed primarily to meet the information needs of **institutional investors in large listed entities**.

Shareholders of SMEs are often also directors. Therefore, through managing the company and maintaining the financial records, they are already aware of the company's financial performance and position and so do not need the level of detail in financial statements required by external institutional investors of larger companies.

The main external **users of SMEs tend to be lenders, trade suppliers and the tax authorities**. They have **different needs** from institutional investors and are more likely to focus on shorter-term cash flows, liquidity and solvency.

Full IFRSs cover a wide range of issues, contain a sizeable amount of implementation guidance and include disclosure requirements appropriate for public companies. This can make them **too complex for users of SMEs to understand**.

Many SMEs feel that following full IFRSs places an unacceptable burden on preparers of SME accounts – a burden that has been growing as IFRSs become more detailed and more countries adopt them. The **cost of following full IFRSs often appears to outweigh the benefits**.

The **disclosure** requirements of full IFRSs are very **extensive** and as such, can result in **information overload** for the users of SME accounts, reducing the understandability of financial statements.

Some IFRSs still offer **choice of accounting treatments**, leading to **lack of comparability** between different companies adopting different accounting standards.

Disadvantages

If SMEs follow their own simplified IFRSs, their accounts are **no longer be comparable** with larger companies following full IFRSs or with SMEs choosing to follow full IFRSs. This may make it harder to attract investors.

The changeover from full IFRSs to the simplified *IFRS for SMEs*, will require training and possible changes in systems. This will place both a **time and cost** burden on the company.

Full IFRSs are now well established and respected and act as a form of **quality control** on financial statements which comply with them. It could be argued therefore that financial statements which no longer comply with full IFRSs will **lose their credibility**. This is often called the 'Big GAAP, Little GAAP divide'.

The *IFRS for SMEs* **reduce disclosures** required by full IFRSs substantially. Omission of certain key information might actually make the financial statements **harder to understand**.

Conclusion

The IASB believes that the advantages for SMEs of having a separate simplified set of IFRSs outweigh the disadvantages. They believe that both preparers and users of SME accounts will benefit.

(b) **Examples of full IFRSs with choice**

(i) Under IAS 40 *Investment property*, either the cost model or fair value model (through profit or loss) are permitted. The *IFRS for SMEs* requires the fair value model (through profit or loss) to be used as long as fair value can be measure without undue cost or effort. This promotes consistency in the treatment of investment properties between SMEs financial statements.

(ii) IAS 16 *Property, plant and equipment* allows assets to be held under the cost or revaluation model. The *IFRS for SMEs* does not permit the revaluation model to be used.

IAS 38 *Intangible assets* allows either the cost model or revaluation model (where there is an active market). The *IFRS for SMEs* does not permit the revaluation model to be used.

Both of these eliminate the use of other comprehensive income, simplifying financial reporting and the need for costly revaluations.

(iii) IFRS 3 *Business combinations* allows an entity to adopt the full or partial goodwill method in its consolidated financial statements. The *IFRS for SMEs* only allows the partial goodwill method, ie excluding non-controlling interests in goodwill. This avoids the need for SMEs to determine the fair value of the non-controlling interests not purchased when undertaking a business combination.

The *IFRS for SMEs* does not eliminate choice completely but disallows the third of the above options. It is one of the rare uses of other comprehensive income under the *IFRS for SMEs*.

Examples of IFRSs with complex recognition and measurement requirements

(iv) IAS 38 *Intangible assets* requires internally generated assets to be capitalised if certain criteria (proving future economic benefits) are met. In reality, it is an onerous exercise to test these criteria for each type of internally generated asset and leads to inconsistency with some items being expensed and some capitalised.

The *IFRS for SMEs* removes these capitalisation criteria and requires all internally generated research and development expenditure to be expensed through profit or loss.

(v) IFRS 3 *Business combinations* requires goodwill to be tested annually for impairment. In reality, it is very difficult to ascertain the recoverable amount for goodwill so instead the assets of the business need to be combined into cash-generating units or even a group of cash-generating units in order to determine any impairment loss. The impairment then needs to be allocated to goodwill and the other individual assets. This is a complex exercise.

The *IFRS for SMEs* requires goodwill to be amortised instead. This is a much simpler approach and the *IFRS for SMEs* specifies that if an entity is unable to make a reliable estimate of the useful life, it is presumed to be ten years, simplifying things even further.

(vi) IAS 20 *Accounting for government grants and disclosure of government assistance* requires grants to be recognised only when it is reasonably certain that the entity will comply with the conditions attached to the grant and the grants will be received. Grants relating to income are recognised in profit or loss over the period the related costs are recognised in profit or loss. Grants relating to assets are either netted off the cost of the asset (reducing depreciation by the amount of the grant over the asset's useful life) or presented as deferred income (and released to profit or loss as income over the useful life of the asset).

The *IFRS for SMEs* simplifies this and specifies that where there are no specified future performance conditions, the grant should be recognised as income when it is receivable. Otherwise, it should be recognised as income when the performance conditions are met.

This is more consistent with the IASB *Framework's* definition of income than the IAS 20 approach.

(vii) IAS 23 *Borrowing costs* requires borrowing costs to be capitalised for qualifying assets for the period of construction. This involves a complex calculation particularly where funds are borrowed generally as a weighted average rate on loans outstanding has to be calculated in order to determine the amount of interest to be capitalised.

The *IFRS for SMEs* requires borrowing costs to be expensed, removing the need for such a complex calculation.

(viii) IAS 36 *Impairment of assets* requires annual impairment tests for indefinite life intangibles, intangibles not yet available for use and goodwill. This is a complex, time-consuming and expensive test.

The *IFRS for SMEs* only requires impairment tests where there are indicators of impairment.

The full IFRS requires impairment losses to be charged firstly to other comprehensive income for revalued assets then to profit or loss. The *IFRS for SMEs* requires all impairment losses to be recognised in profit or loss, given that tangible and intangible assets cannot be revalued under the *IFRS for SMEs*.

27 Barcelona and Madrid

BARCELONA GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X6

	$m
Non-current assets	
Property, plant & equipment (2,848 + 354 + (W6) 18)	3,220
Patents	45
Goodwill (W2)	26
	3,291
Current assets	
Inventories (895 + 225)	1,120
Trade and other receivables (1,348 + 251)	1,599
Cash and cash equivalents (212 + 34)	246
	2,965
	6,256
Equity attributable to owners of the parent	
Share capital	920
Retained earnings (W3)	2,238
General reserve (W4)	796
	3,954
Non-controlling interests (W5)	202
	4,156
Non-current liabilities	
Long-term borrowings (558 + 168)	726
Current liabilities	
Trade and other payables (1,168 + 183)	1,351
Current portion of long-term borrowings	23
	1,374
	6,256

Workings

1 *Group structure*

Barcelona
|
| 60% (1.10.X2)
|
Madrid

2 *Goodwill*

	$m	$m
Consideration transferred (250m x 60% × $1.06)		159
Non-controlling interests at fair value		86
Net assets at acquisition as represented by:		
Share capital	50	
Retained earnings	104	
General reserve	11	
Fair value adjustments (W6)	34	
		(199)
Goodwill at acquisition		46
Impairment losses to date		(20)
Goodwill at year end		26

3 *Retained earnings*

	Barcelona $m	*Madrid* $m
Per question	2,086	394
Pre-acquisition		(104)
Movement on fair value adjustment (W6)		(16)
		274
Group share of post acquisition retained earnings:		
Madrid (274 × 60%)	164	
Less: group impairment losses to date (20 x 60%)	(12)	
	2,238	

4 *General reserve*

	Barcelona $m	*Madrid* $m
Per question	775	46
Pre-acquisition		(11)
		35
Group share of post acquisition general reserve:		
Madrid (35 × 60%)	21	
	796	

5 *Non-controlling interests*

	$m
NCI at acquisition (W2)	86
NCI share of post acquisition:	
Retained earnings ((W3) 274 × 40%)	110
General reserve ((W4) 35 × 40%)	14
Goodwill impairment (20 x 40%)	(8)
	202

6 Fair value adjustments

	Acquisition date	Movement	Year end
	$m	$m	$m
Inventories	8	(8)	-
Land	6	-	6
Buildings	20	(8)*	12
	34	(16)	18

* 20 / 10 years x 4

28 Reprise

REPRISE GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X4

	$'000
Non-current assets	
Land and buildings	3,350
Plant and equipment (1,010 + 2,210)	3,220
Motor vehicles (510 + 345)	855
Goodwill (W4)	826
	8,251
Current assets	
Inventories (890 + 352 – (W2) 7.2)	1,234.8
Trade receivables (1,372 + 514 – 39 – (W3) 36)	1,811
Cash and cash equivalents (89 + 39 + 51)	179
	3,224.8
	11,475.8
Equity attributable to owners of the parent	
Share capital	1,000
Revaluation surplus	2,500
Retained earnings (W7)	5,257.3
	8,757.3
Non-controlling interest (W6)	896.5
	9,653.8
Non-current liabilities	
10% debentures	500
Current liabilities	
Trade payables (996 + 362 – (W3) 36)	1,322
	11,475.8

Workings

1 *Group structure*

R

75% ∴ non-controlling interest = 25%

E

2 *Unrealised profit on inventories*

Unrealised profit included in inventories is:

$$\$31,200 \times \frac{30}{130} = \$7,200$$

3 *Trade receivables/trade payables*

Intragroup balance of $75,000 is reduced to $36,000 once cash-in-transit of $39,000 is followed through to its ultimate destination.

4 *Goodwill*

	$'000	$'000
Consideration transferred		2,000
Non-controlling interest (125,000 × $4.40)		550
		2,550
Net assets acquired as represented by:		
Share capital	500	
Retained earnings	1,044	
		(1,544)
Goodwill at acquisition		1,006
Impairment losses to date		(180)
Goodwill at end of reporting period		826

Goodwill – alternative working

	$'000	$'000
Consideration transferred		2,000
Net assets acquired	1,544	
Group share 75%		(1,158)
Goodwill attributable to parent		842
Impairment (180 × 75%)		(135)
		707
Goodwill attributable to NCI (W5)		164
Impairment (180 × 25%)		(45)
		119
Total goodwill (707 + 119)		826

5 *Goodwill attributable to non-controlling interest*

	$'000
Non-controlling interest at fair value (W4)	550
Share of net assets at acquisition (1,544 × 25%)	(386)
	164

6 *Non-controlling interest at year end*

	$'000
Share of Encore's net assets at 31 March 20X4 (3,110 × 25%)	777.5
Goodwill (W5)	164
	941.5
Goodwill impairment (180 × 25%)	(45)
	896.5

Note: Goodwill impairment charged to the NCI is in proportion to the NCI shareholding.

7 *Consolidated retained earnings*

	Reprise $'000	*Encore* $'000
Per question	4,225	2,610
PUP (W2)	(7.2)	
Pre-acquisition retained earnings		(1,044)
	4,217.8	1,566
Encore – share of post acquisition retained earnings (1,566 × 75%)	1,174.5	
Less goodwill impairment losses to date (180 × 75%)	(135)	
	5,257.3	

29 War

Tutor's hint. This question may look intimidating because it involves an acquisition part of the way through the year, some fair value issues and both the consolidated statement of profit or loss and statement of financial position. It is, however, fairly straightforward.

WAR GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 20X7

	$'000
Assets	
Non-current assets	
Property, plant and equipment (1,750 + 350 + 150)	2,250
Goodwill (W3)	189
	2,439
Current assets	
Inventories	600
Receivables	451
Cash at bank and in hand	299
	1,350
Total assets	3,789
Equity and liabilities	
Ordinary shares of $1 each	750
Share premium (W6)	250
Retained earnings (W5)	659
Non-controlling interest (W4)	255
	1,914
Non-current liabilities	1,225
Current liabilities	650
Total equity and liabilities	3,789

WAR GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 20X7

	$'000
Revenue	3,445
Cost of sales	(1,788)
Gross profit	1,657
Distribution costs	(638)
Administrative expenses (W7)	(310)
Operating profit	709
Interest payable	(75)
Profit before tax	634
Income tax	(306)
Profit for the year	328
Attributable to:	
Owners of the parent	317
Non-controlling interest	11
	328

Workings

1 *Fair value adjustment*

	$'000
Peace Co: property, plant and equipment at fair value	500
Carrying value	350
Fair value adjustment	150

Tutor's hint. Before you can work out the goodwill, you need to work out the pre-acquisition element of the dividend, as this will give you the cost of the investment.

2 *Pre-acquisition dividend*

Dividend paid by Peace to War: $42,000

Pre-acquisition element $^{10}/_{12} \times$ \$42,000 = \$35,000

3 *Goodwill*

	\$'000	\$'000
Consideration transferred		800
Less pre-acquisition dividend (W2)		(35)
		765
Non-controlling interest (823 × 30%)		247
Share capital	100	
Share premium	150	
Fair value adjustment (W1)	150	
Retained earnings		
Prior year: 450 – 165 (225 – 60)	285	
Current year: $^{10}/_{12} \times 165$	138	
Total net assets		(823)
Goodwill		189

Goodwill – alternative working

	\$'000	\$'000
Consideration transferred		765
Total net assets	823	
Group share 70%		(576)
Goodwill		189

4 *Non-controlling interest at year end (statement of financial position)*

	\$'000
Peace Co net assets (1,125 – 175 – 250)	700
Fair value adjustment (W1)	150
	850
× 30%	255

5 *Retained earnings*

	War Co	*Peace Co*
	\$'000	\$'000
Per statement of financial position	625	450
Pre-acquisition dividend	(35)	
Issue costs	50	
Pre-acquisition profits:		
Prior year (450 – 165 (W3))		(285)
10 months to 1 May 20X7 ((450 – 285)× 10/12)		(138)
		27
Group share of Peace (70% × 27)	19	
Group retained earnings	659	

6 *Share premium account*

	\$'000
War Co	300
Less issue costs	(50)
	250

7 *Administrative expenses*

	$'000
War Co	325
Peace Co ($^2/_{12} \times 210$)	35
	360
Less issue costs	(50)
	310

8 *Non-controlling interest (statement of profit or loss)*

$\$225{,}000 \times {}^2/_{12} \times 30\% = \$11{,}250$

30 Fallowfield and Rusholme

(a) FALLOWFIELD GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 20X8

	$
Revenue (403,400 + 193,000 – 40,000)	556,400
Cost of sales (201,400 + 92,600 – 40,000 + 4,000)	(258,000)
Gross profit	298,400
Distribution costs (16,000 + 14,600)	(30,600)
Administrative expenses (24,250 + 17,800)	(42,050)
Profit before tax	225,750
Income tax expense (61,750 + 22,000)	(83,750)
PROFIT FOR THE YEAR	142,000
Profit attributable to:	
Owners of the parent	125,200
Non-controlling interests (W2)	16,800
	142,000

STATEMENT OF CHANGES IN EQUITY (EXTRACT)

	Retained earnings $
Balance at 1 July 20X7 (W3)	190,000
Dividends	(40,000)
Profit for the year	125,200
Balance at 30 June 20X8 (W4)	275,200

Workings

1 *Group structure*

Fallowfield

60% three years ago
Pre-acquisition ret'd earnings: $16,000

Rusholme

2 *Non-controlling interests*

	$
Rusholme – profit for the year	46,000
Less: PUP (40,000 × ½ × 25/125)	4,000
	42,000
Non-controlling interest share 40%	16,800

3 *Retained earnings brought forward*

	Fallowfield	Rusholme
	$	$
Per question	163,000	61,000
Pre-acquisition retained earnings		(16,000)
		45,000
Group share of post acquisition retained earnings:		
Rusholme (45,000 × 60%)	27,000	
	190,000	

4 *Retained earnings carried forward*

	Fallowfield	Rusholme
	$	$
Per question	238,000	82,000
PUP	–	(4,000)
Pre-acquisition retained earnings		(16,000)
		62,000
Group share of post acquisition retained earnings:		
Rusholme (62,000 × 60%)	37,200	
	275,200	

(b) IFRS 3 *Business combinations* states that shares offered as consideration should be valued at fair value, which for listed shares will be market price on the date of acquisition. However, the standard acknowledges that the market price may be difficult to determine if it is unreliable because of an inactive market. In particular, where the shares are not listed, there may be no suitable market. In such cases the value must be estimated using the best methods available. This may involve the use of:

(i) The value of similar listed securities
(ii) The present value of the cash flows of the shares
(iii) Any cash alternative which was offered
(iv) The value of any underlying security into which there is an option to convert

It may be necessary to undertake a valuation of the company in question should none of the above methods prove feasible.

Direct expenses incurred such as professional fees of lawyers and accountants also form part of the cost of the combination. However, issue costs of equity are treated as a deduction from the proceeds of the equity issue, rather than part of the cost of the combination.

31 Panther Group

PANTHER GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	$'000
Revenue [22,800 + (4,300 × 6/12) – (640 × 6/12)]	24,630
Cost of sales [13,600 + (2,600 × 6/12) – (640 × 6/12) + (W3) 10 + (W5) 5]	(14,595)
Gross profit	10,035
Distribution costs (2,900 + (500 × 6/12))	(3,150)
Administrative expenses (1,800 + (300 × 6/12))	(1,950)
Finance costs [200 + (70 × 6/12) – (W4) 20 cancellation]	(215)
Finance income (50 – (W4) 20 cancellation)	30
Profit before tax	4,750
Income tax expense [1,300 + (220 × 6/12)]	(1,410)
PROFIT FOR THE YEAR	3,340
Other comprehensive income for the year, net of tax [1,600 + (180 × 6/12)]	1,690
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	5,030

Profit attributable to:	
Owners of the parent (3,340 – 116)	3,224
Non-controlling interests (W2)	116
	3,340
Total comprehensive income attributable to:	
Owners of the parent (5,030 – 152)	4,878
Non-controlling interests (W2)	152
	5,030

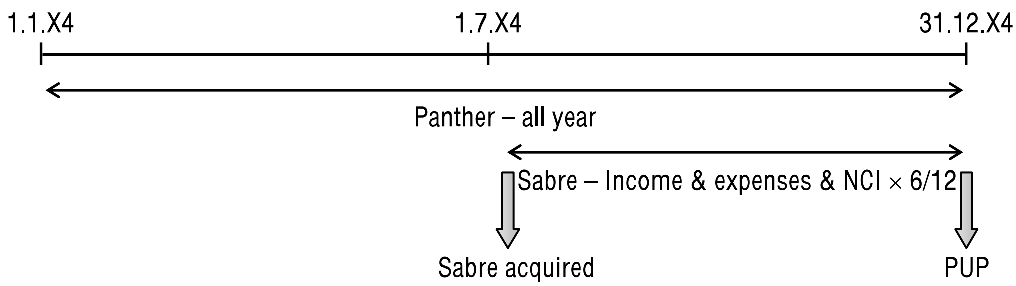
CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACT)

	$'000
	Reserves
Balance at 1 January 20X4 (Panther only)	12,750
Dividend paid	(900)
Total comprehensive income for the year	4,878
Balance at 31 December 20X4 (W6)	16,728

Workings

1 *Timeline*



2 *Non-controlling interests*

	PFY	*TCI*
	$'000	$'000
Profit/TCI for the year (610 × 6/12)/(790 × 6/12)	305	395
Less: PUP (W3)	(10)	(10)
Additional depreciation on fair value adjustment (W5)	(5)	(5)
	290	380
NCI share (× 40%)	116	152

3 *Unrealised profit on intragroup trading*

Sabre to Panther = $\$60{,}000 \times \dfrac{20\%}{120\%} = \$10{,}000$

Adjust cost of sales and non-controlling interests in books of seller (Sabre).

4 *Interest on intragroup loan*

The loan is an intragroup item for the last 6 months of the year (ie only since Sabre's acquisition by Panther):

$\$800{,}000 \times 5\% \times 6/12 = \$20{,}000$

Cancel in books of Panther and Sabre.

5 *Fair value adjustments*

	At acq'n 1.7.X4	*Movement*		*At year end 31.12.X4*
	$'000	$'000		$'000
Property	200	(200/20 × 6/12)	(5)	195

6 *Group reserves carried forward (proof)*

	Panther	*Sabre*
	$'000	$'000
Reserves per question	16,500	3,270
PUP (W3)		(10)
Fair value movement (W5)		(5)
Pre acquisition reserves [2,480 + ((610 + 180) × 6/12)]		(2,875)
		380
Group share of post acquisition reserves:		
Sabre (380 × 60%)	228	
	16,728	

32 Hever

(a) CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant & equipment (370 + 190 + (W7) 45)	605
Goodwill (W2)	8
Investment in associate (W3)	165
	778
Current assets	
Inventories (160 + 100 – (W6) 1.5)	258.5
Trade receivables (170 + 90)	260
Cash (50 + 40)	90
	608.5
	1,386.5
Equity attributable to owners of the parent	
Share capital	200
Share premium reserve	100
Retained earnings (W4)	758.5
	1,058.5
Non-controlling interests (W5)	168
	1,226.5
Current liabilities	
Trade payables (100 + 60)	160
	1,386.5

Workings

1 *Group structure*

Hever

$\frac{48{,}000}{80{,}000} = 60\%$ $\frac{15{,}000}{50{,}000} = 30\%$

Pre-acq'n reserves $20k $150k

Spiro Aldridge

∴ In the absence of information to the contrary, Spiro is a subsidiary, and Aldridge an associate of Hever.

2 *Goodwill on consolidation - Spiro*

	$'000	$'000
Consideration transferred		128
Non-controlling interests (at 'full' fair value)		90
Net assets at acquisition:		
Share capital	80	
Retained earnings	20	
Share premium	80	
Fair value adjustments (W7)	30	
		(210)
Goodwill arising on consolidation		8

3 *Investment in associate*

	$'000
Cost of associate	90
Share of post-acquisition retained reserves (W4)	75
	165

4 *Retained earnings*

	Hever $'000	*Spiro* $'000	*Aldridge* $'000
Per question	568	200	400
PUP (W6)	(1.5)	–	–
Fair value movement (W7)		15	
Pre-acquisition retained earnings		(20)	(150)
		195	250
Group share of post acquisition ret'd earnings:			
Spiro (195 × 60%)	117		
Aldridge (250 × 30%)	75		
Less: group share of impairment losses to date	(0)		
Less: impairment losses on associate to date	(0)		
	758.5		

5 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	90
NCI share of post acquisition ret'd earnings ((W4) 195 × 40%)	78
	168

6 *Unrealised profit on inventories*

Mark-up: \$16,000 – \$10,000 = \$6,000 ∴ ¼ × \$6,000 = \$1,500

7 *Fair values – adjustment to net assets*

	At acquisition	*Movement*	*At year end*
Property, plant and equipment	50	(5)	45
Inventories	(20)	20	0
	30	15	45

(b) Treatment of construction contracts in the statement of financial position of Hever at 31 December 20X4.

	A $'000	*B* $'000	*C* $'000	*Total* $'000
Gross amounts due from customers (Note 1)	80	–	–	80
Trade receivables (Note 2)	–	–	–	–
Gross amounts due to customers (Note 1)	–	(25)	(45)	(70)

Note 1

	A $'000	*B* $'000	*C* $'000
Gross amounts due from/to customers			
Contract costs incurred	500	550	320
Recognised profits less losses	120	(100)	35
	620	450	355
Less: progress billings to date	(540)	(475)	(400)
	80	(25)	(45)

Note 2

	A $'000	*B* $'000	*C* $'000
Trade receivables			
Progress billings to date	540	475	400
Less: cash received	(540)	(475)	(400)
	–	–	–

(c)

		Contract		
	A $'000 *(W1)*	*B* $'000 *(W2)*	*C* $'000 *(W3)*	*Total* $'000
Revenue	600	500	350	1,450
Expenses	(480)	(550)	(315)	(1,345)
Expected loss	–	(50)	–	(50)
Gross profit/(loss)	120	(100)	35	55

Workings

1 *Contract A*

	$'000
Statement of profit or loss	
Revenue (60% × 1,000)	600
Expenses (60% of 800	(480)
Gross profit	120

2 *Contract B*

	$'000
Statement of profit or loss	
Revenue (50% × 1,000)	500
Expenses (all costs to date)	(550)
Expected losses	(50)
Gross profit	(100)

3 *Contract C*

	$'000
Statement of profit or loss	
Revenue (35% × 1,000)	350
Expenses (35% × 900)	(315)
Gross profit	35

List of Key Terms and Index

Note: are **Key Terms** and their page references given in **bold.**

Notes

REVIEW FORM

Please help us to ensure that the Dip IFR learning materials we produce remain as accurate and user-friendly as possible. We cannot promise to answer every submission we receive, but we do promise that it will be read and taken into account when we update this Study Text.

Name: ______________________ **Address**: ______________________

____

How have you used this Text?
(Tick one box only)

☐ Home study (book only)

☐ On a course: college ______________

☐ With 'correspondence' package

☐ Other ______________________

Why did you decide to purchase this Text?
(Tick one box only)

☐ Have used BPP Texts in the past

☐ Recommendation by friend/colleague

☐ Recommendation by a lecturer at college

☐ Saw advertising

☐ Other ______________________

During the past six months do you recall seeing/receiving any of the following?
(Tick as many boxes as are relevant)

☐ Our advertisement in *ACCA's publication*

☐ Our brochure with a letter through the post

☐ Website

Which (if any) aspects of our advertising do you find useful?
(Tick as many boxes as are relevant)

☐ Prices and publication dates of new editions

☐ Information on text content

☐ Facility to order books off-the-page

☐ None of the above

Your ratings, comments and suggestions would be appreciated on the following areas

	Very useful	*Useful*	*Not useful*
Introductory section	☐	☐	☐
Learning objectives	☐	☐	☐
Executive summaries	☐	☐	☐
Quality of explanations	☐	☐	☐
Examples	☐	☐	☐
Questions and answers in each chapter	☐	☐	☐
Illustrative diagrams	☐	☐	☐
Exam focus points	☐	☐	☐
Icons	☐	☐	☐
Chapter roundups	☐	☐	☐
Practice question bank	☐	☐	☐
Answer bank	☐	☐	☐
Index	☐	☐	☐

	Excellent	*Good*	*Adequate*	*Poor*
Overall opinion of this Text	☐	☐	☐	☐

Do you intend to continue using BPP Products? ☐ Yes ☐ No

Please note any further comments and suggestions/errors on the reverse of this page

Please return to: Benjamin Smith, BPP Learning Media Ltd, FREEPOST, London, W12 8AA or email benjaminsmith@bpp.com

ACCA Diploma in International Financial Reporting (10/14)

REVIEW FORM

Please note any further comments and suggestions/errors below